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Darien Shanske

UC Hastings College of the Law, shansked@uchastings.edu

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ABOVE ALL ELSE STOP DIGGING: LOCAL GOVERNMENT LAW AS A (PARTIAL) CAUSE OF (AND SOLUTION TO) THE CURRENT HOUSING CRISIS

Darien Shanske*

So many things have gone wrong with our housing market that it is hard to know where to start. One simple diagnosis is that we invested too much in houses that were not worth as much as we thought. Looked at in this way, it is relatively easy to see how innovations like interest-only loans contributed to an over-valuation of housing. Certain actions of the federal government were and are also clearly problematic, such as the longstanding tax breaks for home ownership.

This Article looks at state and local government law, and particularly at financing mechanisms created by state law and used by local governments to subsidize new development. In essence, local governments issued bonds to build key infrastructure for new developments, and interest on those bonds were exempt from state and federal income taxes. This Article maintains that these mechanisms served as yet another subsidy to the very same kinds of value-destroying housing developments that were already being over-encouraged in other ways. Just as the current crisis has rightly led policymakers to reconsider government actions at the federal level, this crisis should also lead to a similar reevaluation of state and local government law, particularly as it intersects with the federal tax exemption for state and local bonds.

However, to do this properly, we must first reconsider the central normative justification for the current local government landscape. This justification is economic and consists of the argument that competition among a multitude of local government entities is efficient. This vision of jurisdictional competition is generally known as the Tiebout model.

This Article makes a series of specific contributions to this rethinking. First, despite arguments by proponents of the Tiebout model to the contrary, it is demonstrated that a full-blown Tiebout model does not release governments at various levels, nor citizens, from making political choices about a just (versus merely efficient) distribution of resources. This is primarily because the legal background rules that set the terms of the competition also select for different equally efficient sets of jurisdictions. From this result it follows that these legal background rules ought to be interrogated as making political choices. A particular type of rule is described in this Article as a “bundling rule.” A bundling rule operates, for instance, by making a

* Associate Professor of Law, University of California Hastings College of Law. The author benefited from the comments of many wise interlocutors, but would like to give special thanks to Joseph Bankman and Barbara Fried. Invaluable guidance was also provided by Michelle Anderson, Chas Cardall, Richard Craswell, Richard Ford, David Gamage, Mark Kelman, and Richard Schragger. All mistakes are the author's own.

certain method of financing schools readily available only to new subdivisions, thus bundling new schools with new development. By opting to make such a method available, state governments are in effect choosing to encourage certain patterns of development. Once this is realized, then there should be no barrier standing in the way of scrapping bundling rules that encourage sprawl.

I. INTRODUCTION

A. A Housing Market Primed for Failure

For most of the last decade, the area around Sacramento, California had one of the fastest growing housing markets in the country.¹ At this point, everyone knows the punch line: this once booming housing market has since crashed precipitously, with effects far beyond a few real estate speculators or subprime borrowers.²

We know that the severity of both the boom and bust were by no means the natural and inevitable result of the business cycle. The list of responsible human actors is long.³ The Federal Reserve kept

1. See, e.g., Hans P. Johnson & Joseph M. Hayes, *California's Newest Neighborhoods*, 5 CAL. COUNTS: POPULATION TRENDS & PROFILES 1, 4-5 (2003) (finding that the Sacramento Area, with 5.3% of the State's neighborhoods, accounted for 11.2% of the State's new neighborhoods); Sue McAllister, *Housing Inflation Remains in Force*, SAN JOSE MERCURY NEWS, Sept. 2, 2004, at 1C (Sacramento home prices increased between 17% and 18% from 2003 to 2004).

2. See, e.g., Scott Cendrowski, *The 2009 Housing Outlook*, FORTUNE, Dec. 22, 2008, at 68 (projecting that Sacramento area real estate will lose another 22% of value in 2009); FED. HOUS. FIN. AGENCY, FOUR-QUARTER PERCENT CHANGE IN FHFA MSA-LEVEL HOUSE PRICE INDEXES (2009) (on file with the University of Michigan Journal of Law Reform), available at http://www.ofheo.gov/hpi_city.aspx (finding that, as of the third quarter of 2008, the Sacramento area had seen home prices decline by about 21% over the previous year); REALTYTRAC, FORECLOSURE ACTIVITY INCREASES 81 PERCENT IN 2008 ACCORDING TO REALTYTRAC U.S. FORECLOSURE MARKET REPORT 2 (2009) (on file with the University of Michigan Journal of Law Reform), available at http://media.modbee.com/smedia/2009/01/15/14/2008_Foreclosure_Market_Report_from_RealtyTrac.source.prod.affiliate.11.pdf (Sacramento metropolitan area has ninth highest foreclosure rate in country for 2008); Jim Wasserman, *Area Real Estate Market Befuddled the Experts for Years*, SACRAMENTO BEE, Jan. 2, 2009, at B1 (observing that the real estate collapse in the area continues to be worse than projected); Matt Woolsey, *America's Most Distressed Housing Markets*, FORBES.COM, Aug. 21, 2008, http://www.forbes.com/2008/08/21/lifestyle-distressed-cities-forbeslife-cx_mw_0821realestate.html (on file with the University of Michigan Journal of Law Reform) (listing Sacramento as the second most distressed housing market in the country).

3. *The New York Times* has produced an authoritative series on the meltdown called *The Reckoning*. Among those called to account are the Federal Reserve, federal politicians, federal regulators, credit agencies, and federal tax breaks. See, e.g., Vikas Bajaj & David Leonhardt, *1997 Tax Break on Home Sales May Have Helped Inflate Bubble*, N.Y. TIMES, Dec. 19, 2008, at A1; Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1; Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES,

interest rates too low. Several Congresses and two Presidents advanced excessive deregulation, and, it seems, the regulators regulated even less than they could have. Various financial players, such as banks and rating agencies, dramatically underestimated risks, often responding to perverse short-term incentives. On the ground, mortgage brokers pushed preposterous loans and consumers all too readily accepted them.

With such a colorful, and still partial, list of villains, one wonders why one should even bother adding another, but we must because we cannot fix the problems until we know how we got to where we are, and where we are is in part a place where we have housing that will likely never be worth what was invested in it. The villain I will add to our list is local government law in general, and in particular certain obscure local government financing mechanisms. How can this be? The short answer is that local government law has systematically subsidized many of the least sustainable aspects of the housing market and often done so under the guise of rigorous theory.

I will begin my illustration of this point with an extreme, but not atypical, example—a golf-course centered gated community outside of Sacramento called Serrano, which began construction in the mid-1990s.⁴ Serrano features large-lot zoning, a golf course, and its own local public schools. It should be noted that golf

Oct. 9, 2008, at A1; Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1; Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1; see also Jeff Madrick, *How We Were Ruined & What We Can Do*, N.Y. REV. OF BOOKS, Feb. 12, 2009, at 15 (reviewing most current analyses of the crisis). None of these analyses, nor any other of the many written about the crisis that I know of, address the role of local government law, much less local public finance.

4. Serrano describes itself as “one of the largest and most prestigious master-planned communities in Northern California.” Serrano FAQs, <http://www.serranoeldorado.com/newhomes-1c.html> (on file with the University of Michigan Journal of Law Reform). I am assuming that no irony was intended to the extent that *Serrano v. Priest*, 557 P.2d 929 (Cal. 1976), is the name of the leading California decision that mandated equalized expenditures on education. Serrano currently has about 3,500 homes and plans for 5,000 in total, with a minimum price of \$500,000. Serrano FAQs, *supra*. Serrano features a golf course and country club. *Id.* Golf course-centered communities have become very popular. See Lior Jacob Strahilevitz, *Exclusionary Amenities in Residential Communities*, 92 VA. L. REV. 437, 468–69 (2006) (“During the 1990s, golf participation intensified, and the United States saw a rapid increase in the number of residential golf course developments. By 2000, forty percent of current golf course construction was residential, and the growth rate of residential golf courses far outpaced the growth rate for real estate developments in general. In Florida, which has more golf courses than any other state, as many as fifty-four percent of golf courses were residential.”). In 2001, I worked on a similar golf course-centered development (900 homes) in the Sacramento area that received tax-exempt financing. Official Statement, Community Facilities District No. 2001-1 (Dry Creek-West Placer) (County of Placer, California) 16 (Nov. 15, 2001). At the time, I counted eleven competing (high-end) developments, five of which (including Serrano) had golf courses. *Id.* at 38–40.

courses are more strongly correlated with race than large-lot zoning—indeed golf is a better proxy for race than income.⁵ This development is, and is likely to remain, economically and racially isolated.⁶ And it gets worse. Serrano is, so far as I can tell, not near any mass transit station and is thus entirely dependent on the automobile. Thus, even if it were a successful development on its

5. Strahilevitz, *supra* note 4, at 465 (“The data suggests that, during the 1990s, golf was a substantially better proxy for race than income and a somewhat better proxy than household wealth. That differential is critical. After all, if income provided a better proxy for race than golf participation did, those interested in residential racial homogeneity could use large lot sizes or occupancy restrictions to exclude African Americans.”). Strahilevitz carefully does not assert that the golf course as an “exclusionary amenity” was “largely responsible” for their explosion in popularity, but he does find the data he collected rather suggestive (as do I). *Id.* at 469.

6. Serrano does advertise diversity: “Residents are a diverse group, ranging from young families to professional couples and empty nesters.” Serrano FAQs, *supra* note 4. This strange line indicates simultaneously that there is common ground in public discourse that exclusionary goals are to be disavowed even as this line also reassures prospective purchasers that diversity is exactly what the development will not provide. The data on the schools at Serrano indicate the hollowness of this claim of diversity. Serrano features two elementary schools and a middle school on site; naturally, these schools are advertised as excellent. See Serrano FAQs, *supra* note 4. The chart below compares these schools to California in general, the Sacramento area, and a downtown school district in Sacramento (about forty-five minutes away, by car). The chart indicates that there was already a great deal of racial segregation without the advent of this development (compare the school district and the county to the whole Sacramento MSA), though clearly the placement of the three new schools in the development only confirmed the trend (and note that the Serrano schools are a large percentage of the entire district of which they are a part). Indeed, the schools in Serrano do achieve even greater income segregation. The school district in downtown Sacramento, ten times larger than the district in which the development is located, is the mirror-image, both in terms of race and class.

SERRANO SCHOOLS IN CONTEXT

	Percentage White Students	Percentage Black Students	Percentage Hispanic Students	Asian or Pacific Islander	Other	Percentage Free/ Reduced Lunch	Percentage English Learners	Total Students
California	30.30%	7.80%	47.60%	8.80%	5.50%	50.10%	24.90%	6,312,103
Sacramento MSA	62.36%	8.94%	16.54%	12.26%	1.38%	N/A	N/A	N/A
Sacramento City Unified School District	21.40%	21.30%	31.20%	22.40%	3.70%	64.30%	28.80%	50,408
El Dorado County	76.90%	1.30%	12.50%	2.60%	6.70%	22%	5%	29,332
Buckeye Union Elementary District	80.70%	1.70%	6.70%	6.30%	4.60%	8.20%	1.60%	4,623
Serrano On-site Elementary School #1	78.60%	0.90%*	6.80%*	10.80%*	2.90%	1.20%	1.70%	660
Serrano On-site Elementary School #2	70.80%	5.30%**	6.30%**	11%**	6.60%	6/60%	2.30%	647
Serrano On-site Middle School	83.80%	1.40%***	4.80%***	7.50%***	2.50%	3.30%	0.70%	878

All data for 2005–06, and, except for the Sacramento MSA, the data is from Ed-Data, available at <http://www.ed-data.k12.ca.us/welcome.asp>.

Sacramento MSA data from RAND California, available at <http://ca.rand.org/stats/popdemo/popraceage.html>

* Out of 660 students, this school had 6 African-American students, 45 Hispanic students and 71 Asian students.

** Out of 647 students, this school had 34 African-American students, 41 Hispanic students and 71 Asian students.

*** Out of 878 students, this school had 21 African-American students, 42 Hispanic students, and 66 Asian students.

own economic terms, Serrano would still be problematic from a socio-economic and environmental perspective.

But now let us consider Serrano as a business failure. Developments like Serrano are obviously particularly vulnerable to higher energy prices.⁷ One might suppose as well that such developments, which charge a premium for exclusivity, would also be particularly vulnerable to an economic downturn.⁸ A development like Serrano therefore, not very desirable on many policy grounds to begin with, represents a risky development pattern that was encouraged by the myriad of means canvassed above, such as the federal tax deduction for home mortgage interest.

There is an obvious way that state and local government law encouraged these kinds of debacles and that is through the law surrounding land use and property taxation. Because local governments are generally funded by property taxes and have the zoning power, they are constantly on the lookout for projects that produce a net-positive property tax flow. Serrano's large houses generated a lot of property tax per resident, and Serrano's wealthy residents could be presumed to need fewer than average services. A multi-family development could not compete.

But there is a less obvious way in which local government law contributed to this debacle. The local schools in Serrano were financed in significant part through the issuance of Mello-Roos

7. See, e.g., Peter S. Goodman, *Fuel Prices Shift Math for Life in Far Suburbs*, N.Y. TIMES, June 25, 2008, at A18.

8. Data on this particular development is hard to come by, though see *supra* note 2 for the region as a whole. One indicator of trouble at Serrano itself is the number of properties that have missed payments on their Mello-Roos taxes (described below) and are facing foreclosure. According to Serrano's website, as of June 2006, 3,500 homes have been built. Serrano FAQs, *supra* note 4. County records indicate that, as of December 2007, 181 homes in the Serrano Mello-Roos tax district were delinquent on their taxes and, as of July 2008, another 50 parcels were delinquent. JOE HARN, EL DORADO COUNTY AUDITOR-CONTROLLER, REPORT ON SPECIAL TAX DELINQUENCIES FOR COMMUNITY FACILITIES DISTRICT NO. 1992-1 AND COMMUNITY FACILITIES DISTRICT NO. 2001-1: RESOLUTIONS AUTHORIZING FORECLOSURE PROCEEDINGS (July 22, 2008) (on file with the University of Michigan Journal of Law Reform), available at <http://www.co.el-dorado.ca.us/bos/wwwroot/attachments/64b947fc-02d2-49e6-8b0a-7a5433102552.pdf>. In general, special tax delinquencies are on the rise in the area and it is the continued melancholy prediction of this observer that there will soon be a wave of Mello-Roos bond defaults that overlays the problems with defaults on home mortgages. Darien Shanske, Note, *Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon*, 26 VA. TAX REV. 709, 744-45 (2007); Loretta Kalb, *Homeowner Delinquencies Rise*, SACRAMENTO BEE, Aug. 23, 2008, at 1B. Additional evidence of trouble afflicting this kind of development abounds. See, e.g., Krissy Clark, *Gated Into Foreclosure*, WEEKEND AM., Dec. 27, 2008, http://weekendamerica.publicradio.org/display/web/2008/12/27/gated_into_foreclosure (on file with the University of Michigan Journal of Law Reform); Anita Huslin, *Golf Course Communities' Double Bogey*, WASH. POST, Aug. 11, 2008, at D1; Dale Kasler, *Winchester Country Club on Track to Be Sold*, SACRAMENTO BEE, Dec. 17, 2008, at B9 (golf course community in Sacramento area bankrupts local developer and is poised to be sold for fraction of its development cost).

bonds,⁹ a type of bond authorized under California law with rough analogues in most states.¹⁰ The details of these bonds were developed in a previous paper,¹¹ but the key fact about Mello-Roos bonds for our purposes is that they are an easy way for developers to build schools in new communities. Indeed, under California law, it is easier to use Mello-Roos bonds to build a new school in a development like Serrano than it is to build or rebuild a school in an existing community. Not surprisingly, these bonds are an extremely common way of financing infrastructure for suburban developments in California.¹²

The interest on Mello-Roos bonds is exempt from state and federal income tax, which is a significant subsidy on top of the federal mortgage deduction.¹³ So local government law, in concert with the

9. Serrano advertises that a Mello-Roos levy of approximately \$820/year goes towards its on-site schools. Serrano Homeowners Association, Dues and Fees, <http://www.serranoeldorado.com/newhomes-lg.html> (on file with the University of Michigan Journal of Law Reform).

10. See Shanske, *supra* note 8, at 712 n.3 (surveying the availability of Mello-Roos bonds and related assessment bonds in various states); see also H.R. 159, 185th Gen. Ct. (Mass. 2007) (proposed bill that would have created a financing structure similar to Mello-Roos in Massachusetts); Jeffrey I. Chapman, *The Fiscalization of Land Use: The Increasing Role of Innovative Revenue Raising Instruments to Finance Public Infrastructure*, 12 PUB. WORKS MGMT & POL'Y 551 (2008) (listing various infrastructure financing techniques).

11. See generally Shanske, *supra* note 8.

12. See *id.* at 727–28 (finding that an estimate that 90% of new development utilized such taxes was plausible); see also Vladimir Kogan & Mathew D. McCubbins, *The Problem with Being Special: Democratic Values and Special Assessments* 15–19 (Feb. 9, 2009) (unpublished manuscript, on file with the University of Michigan Journal of Law Reform), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1277522 (finding widespread use of Mello-Roos type districts in California).

13. And there is still more subsidy from the federal government if the residents deduct the local (usually Mello-Roos) taxes used to secure the tax-exempt bonds. Pragmatically, one supposes that it is likely that most people deduct all of these taxes (if they deduct at all), though as a matter of law (and theory) the question is closer. The taxes should not be deducted if they are “[t]axes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not prevent the deduction of so much of such taxes as is properly allocable to maintenance or interest charges.” I.R.C. § 164(c)(1) (2006). The idea is that if the taxes are like a private expense that one will recoup later, then they are no more deductible than any other home improvement. In any event, the interest portion is deductible, but the principal portion is not deductible to the extent that the benefits tend to increase the value of the property. In a project like Serrano, it is a complicated question just how much of the principal is being impounded into home value. For the inherent complexity in making sense of this deduction, which costs the federal government \$75 billion per year, see Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 IND. L.J. 673 (2007); Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413 (1996); see also California Franchise Tax Board, *Are Mello-Roos Taxes Deductible on Your Personal Income Tax Return?*, <http://www.ftb.ca.gov/individuals/faq/net/909.html> (on file with the University of Michigan Journal of Law Reform) (state of California warning that principal on Mello-Roos taxes are not likely deductible). It is interesting that the federal tax code seems to assume that most property taxes do not add to property

federal law of tax exemption, not only encouraged this pattern of development, but subsidized it. Though hard to quantify, some non-trivial amount of development would not have occurred, or would have occurred differently, if not for these influences.¹⁴ We can be fairly confident that these bonds had some effect in spurring sprawl-type development because, as noted above, during the recent boom in California developers used Mello-Roos taxes in connection with most new developments. This issue needs to be understood, and quickly, not only because the federal government is embarking on large infrastructure expenditures in general, but on expenditures specifically meant to stimulate more sustainable development patterns.¹⁵ This means that the federal government will soon expend even more resources directly in part to undo the damage done by its indirect subsidies.

This point can be stated succinctly in numbers. Suppose, based on traditional criteria and assuming that housing is not tax-advantaged, I could afford a \$330,000 home. This assumes a 6% interest rate on a thirty-year fixed rate mortgage, with a \$2,000/month payment.¹⁶ Suppose as well that financial innovations, such as an interest-only or shorter term adjustable rate mortgage, led me to believe that I could afford a \$415,000 home (this is based on a 4% interest rate over thirty years). Now add in

value (hence are deductible), while it believes a subset of such taxes (usually called "assessments," see later discussion) usually do add to property value.

14. The federal tax system encouraged investment in housing in yet another way through, speaking roughly, excluding a sizable portion of the capital gain on most principal residences from capital gains taxes (\$500,000 for a joint return). I.R.C. § 121. This was a change to the tax law, made in 1997, which has been found to have had a measurable impact on housing sales. Hui Shan, *The Effect of Capital Gains Taxation on Home Sales: Evidence from the Taxpayer Relief Act of 1997* (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Paper No. 2008-53, 2008) (on file with the University of Michigan Journal of Law Reform), *available at* <http://www.federalreserve.gov/pubs/feds/2008/200853/200853abs.html>. There is no reason to believe that the subsidy provided by Mello-Roos taxes did not similarly affect the housing market.

15. For example, several of the key federal agencies, the Department of Transportation, the Environmental Protection Agency, and the Department of Housing and Urban Development, have recently agreed to work together towards building "sustainable communities." HUD, DOT and EPA Partnership: Sustainable Communities (June 16, 2009) (on file with the University of Michigan Journal of Law Reform), *available at* <http://www.epa.gov/smartgrowth/pdf/dot-hud-epa-partnership-agreement.pdf>; *see also* JEFFREY J. SMITH & THOMAS GHIRING, *FINANCING TRANSIT SYSTEMS THROUGH VALUE CAPTURE: AN ANNOTATED BIBLIOGRAPHY* (2006); TRANSIT COOP. RESEARCH PROGRAM, *TRANSIT-ORIENTED DEVELOPMENT IN THE UNITED STATES: EXPERIENCES, CHALLENGES, AND PROSPECTS* 460 (2004) (recent federally commissioned report recommending, among much else, the use of land-value financing to encourage more sustainable development).

16. These numbers are fictional, though reasonable so as to illustrate the point that in some cases the state and local government-related subsidies alone amounted to most of the premium for living at a development like Serrano (at least as such subsidies were perceived by the homebuyers).

only the subsidy from the federal government through the home mortgage deduction. Assuming a marginal tax rate of 20%, then I can now afford a home of about \$500,000.¹⁷ As for the federal and state tax exemption on the bonds, let us assume that they allow a developer to take about \$20,000 off of the home price,¹⁸ meaning that I am now able to afford a \$520,000 home—that is, all together two-thirds more home than I could afford without (only the specified!) government interference.

To stay with the particular problem that is the focus of this Article: one estimate of the exclusivity premium people paid for golf course living was \$30,000.¹⁹ If this is so, this would mean that, under the best of circumstances, the federal and state governments have more than subsidized my choice to live in a racially and economically exclusive community like Serrano, with the benefit of the tax exemption in the example above plausibly covering two-thirds of this premium. This is a dubious choice of subsidy on any number of grounds. Once the market and economy turns, developments like Serrano will have, and have had, their home values plummet, with homes quite possibly selling for less than they cost to build—and so now the state and federal governments have subsidized housing that is value-destroying from any perspective.

It may be that denser smarter development will never appeal much to local governments as much as would be ideally desirable so long as local governments rely on the property tax. This problem could be in part addressed by subsidizing denser development and there are, of course, such programs. Yet even based on the rough calculations presented above, it seems clear that the subsidy given to sprawl-type development is much larger than the direct subsidy given to more sustainable development. And even if there were a greater net subsidy for smart growth, there is no reason sprawl-pattern exclusionary development should get *any* subsidy at all; indeed, to the extent it generates externalities, such as segregation, local government law should be organized to make such development more expensive, not cheaper.

B. The Tiebout Model as Obstruction to Course Correction

One way forward is clear. Subsidies like Mello-Roos financing should only be made available for sustainable residential develop-

17. This is because I am now paying (about) \$2,400 per month on the assumption that most of this payment will be deductible mortgage interest. I.R.C. § 163(h)(3).

18. For the plausibility of this analysis, see Shanske, *supra* note 8, at 741–42, 751–62.

19. Huslin, *supra* note 8.

ment.²⁰ If a state will not adjust its financing laws accordingly, then the federal government can withhold infrastructure-related funds or, still more directly, deny any such sprawl-subsidizing bonds the federal tax exemption.²¹

What is standing in the way?² Ideology, it seems. As it stands now, Mello-Roos bonds in California cannot even be used to subsidize affordable housing. Further, as it stands now, Mello-Roos bonds also cannot be used to subsidize alternative energy. The California Legislature acted to change both of these limitations,²² though not, sadly, to prohibit the use of Mello-Roos bonds for developments like Serrano altogether.²³ Both times Governor Schwarzenegger vetoed the legislation.²⁴ The error in the Governor's analysis is

20. There is no better time for such a dramatic change to Mello-Roos law because the collapse of the housing market means that virtually no such bonds are currently being issued and there is presumably little expectation that this is going to change any time soon. See CAL. DEBT & INV. ADVISORY COMM'N, CALIFORNIA MELLO-ROOS COMMUNITY FACILITIES DISTRICTS YEARLY FISCAL STATUS REPORTS AND REPORTS ON DRAWS ON RESERVES AND DEFAULTS 3 (2007) (on file with the University of Michigan Journal of Law Reform), available at <http://www.treasurer.ca.gov/cdiac/reports/M-Roos/2007.pdf>. Therefore, the cost in disrupted reliance interests would be minimal.

21. There are already very complicated regulations governing the use of tax-exempt bonds, particularly as concerns "private use," with a paradigm question being whether it is permissible to use tax-exempt bonds to build a sports stadium. See 26 C.F.R. § 1.141-0 to -16 (2009). It might be prohibitively difficult to craft a rule barring the use of tax-exempt proceeds in a case like Serrano, assuming that we wish to retain the tax-exemption for projects that undertake to build infrastructure and schools (I am not sure that we should have the tax-exemption at all). I am not convinced, however, that such a rule is impossible and, in fact, the IRS did promulgate proposed regulations that would likely have had this effect, but these proposals were scaled back upon encountering opposition. See Definition of Private Activity Bonds, 62 Fed. Reg. 2275, 2276, 2279 (Jan. 16, 1997) (discussing changes to proposed regulations in order not to interfere with "with traditional tax assessment bond financings"). Bonds used for projects like Serrano have some particular characteristics that I think can be picked out and prohibited. Unlike most bonds issued by governments, they are secured by the land and not by a promise of the jurisdiction to tax. Furthermore, the bond proceeds are generally used to purchase the public improvements from the developer, and so it is common in these transactions that the developer must show the wherewithal to finance the projects on her own. A sensible rule could be that the federal tax-exemption is not to be used for land-secured financings and/or financings where the tax-exempt proceeds essentially "take out" a private financing. The proposed regulation achieved much the same thing by forbidding "the use of bond proceeds to provide property that discharges a primary and unconditional legal obligation of a nongovernmental person." *Id.* at 2276. Another alternative approach might limit the use of tax-exemption geographically. That is, the federal tax-exemption is not available for land-secured financing outside of certain development zones. Maryland, for instance, already has a similar law. See MD. CODE ANN., STATE FIN. & PROC. § 5-7B-01 (2008) (restricting state funding to priority areas).

22. S.B. 1432, 2005–06 Leg. Sess. (Cal. 2006); A.B. 1709, 2007–08 Leg. Sess. (Cal. 2008).

23. Cf. H.R. 159, 185th Gen. Ct. (Mass. 2007) (proposed Massachusetts law would not have allowed Mello-Roos type financing for schools or for "gated communities").

24. VETO MESSAGE, S.B. 1432, 2005–06 Leg. Sess. (Cal. 2006); SENATE FLOOR ANALYSIS OF S.B. 1432, 2005–06 Leg. Sess., at 10–11 (Cal. 2006) (statement of California Association of Realtors); VETO MESSAGE, A.B. 1709, 2007–08 Leg. Sess. (Cal. 2008).

deep and fundamental. In particular, the Governor and his allies on this issue seem to believe that financing mechanisms like Mello-Roos are a neutral market mechanism and do not represent a political choice as to what kind of communities we want.²⁵ From this perspective, allowing Mello-Roos bonds to be used for politically desirable ends is an unwarranted intrusion. Yet Mello-Roos bonds are already a government intrusion into the housing market that encourages less affordable and less sustainable development patterns.

Why can the Governor not see this? It is because local governments are surmised to be quasi-market actors and therefore the State should leave them alone to the extent possible. Making Mello-Roos financing available to local governments is supposedly allowing the market to work, whereas redirecting some of the subsidy these bonds represent to affordable housing is unfair social engineering.

What is the theory of local governments that compares them to private entities in this way, and why has it been so persuasive? This dominant theory of local governments is called the Tiebout model, and it is the Tiebout model that must be very seriously reconsidered before common sense local government reforms can commence. In particular, this Article argues that the Tiebout model requires the making of political decisions about the allocation of public goods at the local level—this despite the insistence of its proponents that there are only market transactions that should be left alone.

The Tiebout model analogizes the choice of where to live with a shopping trip and purportedly demonstrates that jurisdictional competition for citizen-consumers can ensure that the right quantity of local public goods is produced at the right price. A functioning Tiebout dynamic is supposed to provide not only the benefit of the efficient use of resources because everyone is getting the amenities they want at the price that they want, but it is also desirable because the property tax in a functioning Tiebout dynamic is acting as a price for a bundle of local goods and services. Since in such a case property taxes are a price that homeowners

25. See, e.g., VETO MESSAGE, S.B. 1432, *supra* note 24 (“[T]his bill also contains a provision that would allow Mello-Roos taxes to be imposed on homeowners in order to finance affordable housing projects. This provision represents a fundamental shift in the purpose of Mello-Roos taxes and is one that I cannot support. While I support the construction of much-needed affordable housing in our state, the burden to finance that construction should not be placed on homeowners in the form of what is essentially a tax increase.”); see also SENATE FLOOR ANALYSIS OF S.B. 1432, *supra* note 24 (statement of California Association of Realtors).

willingly pay by choosing a jurisdiction, the property tax, unlike other taxes, causes comparatively less deadweight loss from evasion of the tax.

Already in Tiebout's original article in 1956, an additional benefit of the model was that its market-approach delivered relative efficiency, at least in comparison to the alternative method of public good provision, which is determining the provision of local public goods through a political process. Although the Tiebout model is desirable on several grounds (at least in theory), in particular its relative allocative efficiency and minimization of deadweight loss, this Article argues that its promise of an escape from political constraints is illusory on two grounds. First, the very selection of a model of jurisdictional competition (i.e., the Tiebout model) is itself a political decision about resource allocation because, among other reasons, the Tiebout model does not allow for redistribution of wealth at the local level. This is so because, if property taxes function as a price for local services, then taxpayers will only pay for services they actually receive. The Tiebout model also represents a political choice to the extent that even its proponents concede it tends to produce sprawl-type development because, for example, homeowners are given incentive to move to more and more exclusive new communities, communities that can offer ever lower taxes because of their ever higher property tax base. Because the negative externalities generated by sprawl must be borne by the greater community outside the jurisdiction (e.g., the costs of traffic congestion), a political choice is made to favor those in the development at the expense of those outside its borders.

The second political constraint, and the one that is the focus of this Article, is that background legal rules will tend to select among possible sets of amenity bundles that are equally efficient, at least pragmatically. If the Tiebout model is to be efficient, then economies of scale dictate that there cannot be bundles for everyone. A corollary to economies of scale is that local public goods tend to be bundled. A properly sized school district will have thousands of inhabitants who will also need to agree on parks, police, etc. Economies of scale and bundling thus indicate that we all live in second-best jurisdictions because everyone will have to compromise on at least some of their preferences. There can be many sets of second-best jurisdictions, and the legal background rules will affect what the available local government bundles will look like. For instance, if annexation by a larger municipality is easy and secession from it difficult, then it is more likely that wealthy enclaves

will be absorbed into larger metropolitan areas, enabling the amenity bundles desired by some citizens, but frustrating the desires of others.

This second constraint is further developed through returning to the example of Serrano, our gated community centered on a golf-course that was subsidized through the use of tax-exempt bonds. The development of a golf-course gated community arguably represents finely grained, and efficient, Tiebout-sorting. However, it also represents a political choice to the extent that the state law rules for the issuance of tax-exempt bonds make it easier to build schools in a new community like this than they make it to build schools in existing communities.

The example of Serrano also brings us back to the beginning of this Article and to the current crisis. Blithely ignoring that politics is even relevant has encouraged local government law to amplify market forces to such an extent that the resulting development pattern cannot even be considered second-best. Billions of dollars of new infrastructure was built in new developments like Serrano using tax-exempt bonds. This was not second-best, but a waste that should not be repeated.

This Article proceeds in two main parts. In Part II, the Tiebout model will be discussed in greater depth. It is essential to understand its strengths, as well as why it is not going anywhere as the dominant model for explaining and justifying our local government landscape. Once we understand the Tiebout model, we will consider its limitations in Part III. Particularly, we will consider why it is, and must be, animated by certain political choices as to the shape of our communities. Once it is clear that even a pure Tiebout-inspired local government regime is not neutral, much less is a landscape dotted with subsidies like Mello-Roos taxes neutral, the ground will be cleared for the kind of reforms outlined in this introductory Part I.

II. WHAT IS THE TIEBOUT MODEL AND WHY WE CANNOT ESCAPE IT

Before we can critique the Tiebout model, we must know what it is and why it matters. This is the task of this Part.

A. Tiebout's Article in its Original Context

Tiebout's famous article was a response to a specific economic question about the provision of public goods posed by the economist Paul Samuelson in two articles in 1954 and 1955. Samuelson maintained that "no decentralized pricing system can serve to determine optimally the[] level[] of collective consumption [of public goods]."²⁶ This is because "it is in the selfish interest of each person to give *false* signals, to pretend to have less interest in a given collective consumption activity than he really had, etc."²⁷ Samuelson ultimately concluded that political deliberation was necessary to the extent that a modern economy relies on the provision of public goods and both articles end with a plea for modesty on the part of economists, conceding a place to other disciplines and even "welfare politics."²⁸

Tiebout glosses Samuelson's analysis this way:

[N]o "market-type" solution exists to determine the level of expenditures on public goods. Seemingly, we are faced with

26. Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 388 (1954) [hereinafter Samuelson, *Pure Theory*].

27. *Id.* at 388–89. Samuelson's next sentence is especially interesting given Tiebout's response:

I must emphasize this: taxing according to a benefit theory of taxation cannot at all solve the computational problem in the decentralized manner possible for the first category of "private" goods to which the ordinary market pricing applies and which do not have the "external effects" basic to the very notion of collective consumption goods.

Id. at 389. Samuelson is indicating that because public goods have the characteristic of allowing one to consume them without revealing how much one is willing to pay, there will still be imperfect revelation of preferences even if taxes were levied according to a benefit principle. Christopher Yoo has recently made the point very clearly:

For private goods, consumers pay the same price and signal the different valuations that they place on the good by purchasing different quantities. For pure public goods, consumers consume the same quantity of production and signal the intensity of their preferences by their willingness to pay different prices.

....

... The problem is that when consumers express the intensity of their preferences through prices rather than quantities, there is no way to induce consumers to reveal their marginal valuations.

Christopher S. Yoo, *Copyright and Public Good Economics: A Misunderstood Relation*, 155 U. PA. L. REV. 635, 638–39 (2007).

28. See Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STAT. 350, 356 (1955); Samuelson, *Pure Theory*, *supra* note 26, at 389.

the problem of having a rather large portion of our national income allocated in a “non-optimal” way when compared with the private sector.²⁹

As a corollary to his search for a market-type solution, Tiebout is trying to determine the “appropriate” level of “benefit taxation”—that is, taxes assessed as a matter of the benefit received rather than “ability to pay”; benefit taxes are more like prices than traditional taxes because the tax paid has an explicit connection with a benefit received.³⁰ The exclusive use of benefit taxes would prevent redistribution at the local level, except to the extent that the local voters actually benefited from redistribution (or at least perceived a benefit).³¹ In short, as Tiebout himself notes, his model is meant to provide an “invisible hand” explanation for as many public goods as possible.³²

Tiebout’s solution to Samuelson’s problem is that citizen-consumers can reveal their preferences for local public goods in the same way that they reveal their preferences for ordinary private goods; the choice of where to live is essentially a shopping trip.³³ The fact that local public goods are spread out in space thus provides the means by which citizen-consumers can reveal their preferences, given that one needs to pay a price to live in a certain jurisdiction. Tiebout recognizes that a market for local public goods will exist to a greater or lesser extent based on a number of assumptions that at best only approximate the real world, including whether there are a sufficient number of communities, mobility, no externalities and whether the individual municipalities are themselves producing local public goods efficiently.³⁴ However, Tiebout argues that, to the extent his model would allocate public goods efficiently, public policy *should* endeavor to make his model more of a reality:

Policies that promote residential mobility and increase the knowledge of the consumer-voter will improve the allocation of government expenditures in the same sense that mobility

29. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 416 (1956).

30. *Id.* at 417 n.8.

31. Cf. Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 478–79 (1996).

32. Tiebout, *supra* note 29, at 422 (quoting Samuelson’s use of this famous phrase from Adam Smith, but Samuelson was describing the operation of a market in *private* goods as different from that of a market in *public* goods).

33. *Id.* at 422.

34. *Id.* at 419.

among jobs and knowledge relevant to the location of industry and labor improve the allocation of private resources.³⁵

Tiebout also considers whether revenue-expenditure patterns should be fixed to facilitate this market mechanism. The idea here is that people should get what they pay for and not be forced to take some other amenity bundle through the *ex post* operation of politics.³⁶

There are other essentially normative arguments in Tiebout's article. For instance, Tiebout notes that his model will work best if the various communities try to achieve their optimal size relative to their stock of public goods (i.e., they seek more people until diminishing returns set in).³⁷ How then to keep people from moving to a community that is "optimum"? Tiebout answers:

The case of the community which is at the optimum size and tries to remain so is not hard to visualize. Again proper zoning laws, implicit agreements among realtors, and the like are sufficient to keep the population stable.³⁸

This passage and others indicate that the Tiebout hypothesis from the start required agreeable background legal rules (such as zoning) to help create a necessarily limited number of optimally-sized communities that would compete with one another. Although jurisdictional competition would obviate the need for political processes deciding on the production and allocation of public goods, Tiebout does not consider from whence the pro-competitive legal rules and other policies would emerge. Nor does Tiebout consider the implications of economies of scale on whether there will need to be political decisions as concerns who will have to compromise on which preferences.

35. *Id.* at 423.

36. *Id.* at 423–24. There is a tension here because one may move into a community wanting to affect some change by use of voice. Perhaps I love golf and have friends within an exclusive golf course community like Serrano, and so I buy a house there, but I also want to vote for changes that will make the development and the schools within it more diverse. This paradox touches on a variety of issues: 1) politics may itself be a desired amenity; 2) amenities tend to be bundled; and 3) there is a gap between the production of public goods and their provision that may itself result in market failure (e.g., for parallel reasons, no developer will build a more diverse development even though such developments are being underproduced). See David Lowery, *Answering the Public Choice Challenge: A Neoprogressive Research Agenda*, 12 GOVERNANCE: INT'L J. POL'Y, ADMIN. & INSTITUTIONS 29, 44–45 (1999).

37. Tiebout, *supra* note 29, at 419.

38. *Id.* at 420.

B. The Tiebout Model

What I am calling the “Tiebout model” is the development of Tiebout’s original idea that efficient production of local public goods can result from jurisdictional competition. Critical additions included zoning³⁹ and the median voter.⁴⁰ I will focus on the model as developed in the recent work of William Fischel. Zoning is conceptually essential because it allows local governments to zone out free-riders. For example, suppose a wealthy suburban school district has excellent schools, paid for by a 2% property tax rate on homes that average \$500,000 in assessed value, or \$10,000 property tax/average home per year. Suppose the primary developer for this subdivision still owns a number of lots at the edge of town⁴¹ and that there are no zoning regulations. The developer can build, say, another four new large single-family homes or a fifty-unit condominium. The individual condominiums will go for a premium because of the school district, but each will sell for less than the single-family homes, say for an average of \$200,000.⁴² In this scenario, the developer is earning a windfall from the *ex ante* investment and continued disproportionate investment⁴³ of the rest of the community in the local schools and other amenities. Of course, in order to sell those first single-family homes at a premium, the developer and/or the municipality probably needed to assure the future homeowners and voters (“homevoters” in Fischel’s parlance) that such a scenario would not occur. Zoning is a very efficient way to achieve this.

In fact, from the beginning, the Supreme Court, in upholding zoning generally, was aware that wealthy homeowners would use zoning powers to prevent lower-income free-riders, “mere para-

39. WILLIAM A. FISCHEL, *THE HOMEVOTER HYPOTHESIS* 65 (2001) (following Hamilton); *see also* Tiebout, *supra* note 29, at 419.

40. FISCHEL, *supra* note 39, at 72.

41. I make this assumption because otherwise the developer would likely have had to pay an amount for the land reflecting its highest and best use.

42. So the developer may sell four homes for \$2 million or fifty condominiums for \$10 million. I am assuming that the likely greater cost of putting up the condominiums still leaves the developer with much more profit. To the extent exclusionary zoning prevents this deal from happening then, at least at this level, exclusionary zoning is causing an efficiency loss because the land is worth more to the potential condominium owners than to the large home owners. Of course, the overall system may be more efficient with exclusionary zoning (e.g., it allows for ever more precise pricing). As discussed *infra*, this question of whether jurisdictional competition is efficient in practice is not the focus of this Article.

43. That is, the average condo owner will only pay \$4,000 a year in property taxes (2% * 200,000) rather than \$10,000. In a perfect market (which is unlikely), the condos should increase in price to fully impound the fact that they represent a tax bargain and the homes should decrease in price to represent that they are subsidizing others. Obviously, this “solution” to the problem of free-riders will not be appealing to the preexisting homeowners.

sites” as the Court put it, in single-family residential neighborhoods.⁴⁴

Fischel postulates that, since so many homeowners have for cultural and economic reasons (including government subsidies) taken a massively undiversified position in their homes, they are powerfully motivated to pressure local governments to protect their property values.⁴⁵ The simple majoritarian model of most local governments (e.g., one city council, no senate) means that the local government level is where the median (home)voter rules.⁴⁶ The conventional view is that homevoters are sensitive to tax and amenity bundles and that the median homevoter rules at the local level.⁴⁷ Indeed, empirical evidence is widely believed to confirm the existence of the Tiebout dynamic more generally (at least to some extent).⁴⁸

C. *The Import of Property Taxation*

To the extent that homevoters are voting with their feet for an amenity bundle, the property tax functions as a price for services they willingly buy.⁴⁹ The more competition there is among jurisdictions, the more likely individuals are to get exactly what they want in exchange for their property taxes. In contrast, for taxes on capital or corporate profits, jurisdictional competition will tend to

44. Vill. of Euclid v. Ambler Realty Co., 272 U.S. 365, 394–95 (1926).

45. FISCHEL, *supra* note 39, at 4, 19.

46. *Id.* at 89.

47. See, e.g., *id.* at 60–61, 88–89.

48. See, e.g., Robert Inman, *Commentary*, in THE TIEBOUT MODEL AT FIFTY 46–53 (William A. Fischel ed., 2006) [hereinafter TIEBOUT AT FIFTY]. Even critics of the Tiebout model acknowledge its relative explanatory power. See, e.g., Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346, 405–06, 416–17 (1990). My interpretation of the (mixed) findings is that the Tiebout model is especially (though not wholly) explanatory of certain market segments, say of housing directed at relatively affluent households with children.

49. Cf. Joseph Bankman, *State Tax Shelters and State Taxation of Capital*, 26 VA. TAX REV. 769, 784 (2007). (“The reason why a typical tax causes substitution away from the taxed activity is that there is no relationship, at the margin, between the tax paid and government services received. A taxpayer does not get any additional government services from working an additional hour and paying the tax on her labor or from saving an additional dollar and paying tax on her interest income. In the Tiebout model, however, the relationship between municipality and taxpayer can be thought of as that between a seller and purchaser. A resident purchases schools for her children with her property tax. The tax does not rise with income, and unless she pays the tax, she cannot live in the city and use its schools. There is a direct relationship between the tax paid and the services received. There is no inefficiency if a taxpayer works to purchase schooling for her children, just as there is no efficiency if the taxpayer works to buy a car.”).

reduce the tax base.⁵⁰ Finally, property taxes play an important role in a taxation system dominated by the income tax, serving as a tax on the imputed income that homeowners enjoy from owning rather than renting.⁵¹ These arguments suggest that whatever the limits of the allocative efficiencies delivered by the Tiebout model or concerns with its distributive consequences, there are other reasons to retain the property tax as a key component of local finance. Thus, even if one is not persuaded that the Tiebout model obtains or provides efficiency gains,⁵² one still needs to consider the impact of jurisdictional competition to the extent one wishes to retain the property tax as a central means for local governments to fund themselves because of its relative merits compared to other taxes.

D. Tiebout and Public Choice

Bratton and McCahery helpfully summarize the relationship between Tiebout and public choice theory as follows:

Public choice proponents countered [the public interest theory of government by claiming] that the “public interest” cannot be meaningfully articulated in the first place, much less utilized as a template for regulation⁵³ [T]he Tiebout model, with its competition-based local public goods equilib-

50. Cf. *id.* at 786 (“[T]he corporate tax, even if levied in what might pass for a ‘pure’ form, does not lead to anything like a Tiebout equilibrium. Instead, those who have modeled the effects of interstate competition on the corporate tax have come to more pessimistic conclusions. In one leading set of models, high corporate taxes cause companies to locate out of state, which in turn reduces in-state employment and wages. States respond by reducing the corporate tax rate. In equilibrium, for states that must rely on the corporate tax, services are underfunded. There are services that would improve welfare (even after allowing for their tax cost) in a world without competition that cannot be provided in a world with tax competition. The models do not state how much services will be underfunded. In general, the models are consistent with (but do not themselves tell) a story of tax competition in which the corporate tax becomes such an expensive and poor source of revenue that it is dropped altogether.”).

51. For compelling arguments for the property tax, with an emphasis on why the property tax has survived and should survive, see Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue with My Younger Self*, 23 CARDOZO L. REV. 2199, 2216–20 (2002); see also Bankman, *supra* note 49, at 788; Frank Shafroth, *The Unsimple Pleasures of Property Taxes—Are Virginia Candidates Looking to the Future or November?*, 36 ST. TAX NOTES 453 (2005).

52. Thus, for instance, one might believe that the current local government system is characterized by an inefficient level of exclusionary zoning that results in inefficiencies, such as sprawl. Yet if one believes in the semi-independent virtues of the property tax, then simply abolishing local jurisdictions is not an option, and so we are bound to consider how we might change the rules governing local jurisdictions to arrive at a more efficient outcome.

53. See also JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* 11–12 (Univ. of Mich. Press 1962) (starting from an attack on the notion of the public interest).

rium, shows up in the analysis to offer a theoretical cure: Since market transactions are the most accurate allocators of resources, government should be structured so that regulation follows not from discussion of the public interest but from the responses of at-the-margin producers. . . . The Tiebout model's prescription of devolution of regulatory authority to junior levels of government tracks a conclusion reached independently in another line of public choice theory. Under this "Leviathan" theory, government actors—particularly those in central government—use their monopolists' positions to pursue governmental revenue maximization. . . . Jurisdictional competition [i.e., Tiebout] theory makes its second contribution in rebuttal to the argument that devolution simply turns regulatory subject matter over to the distortive manipulations of state and local interest groups. The disciplinary effect of competition across states and localities minimizes local capture losses.⁵⁴

Though the embrace of Tiebout by public choice theorists may be somewhat ad hoc,⁵⁵ Bratton and McCahery make a compelling case that the existence of robust jurisdictional competition helps explain why it is advisable from a public choice perspective to devolve regulatory powers to the state and local governments. The answer is, much as in Tiebout's original response to Samuelson, that local governments are constrained by competition and the central government is not (or to a much lesser degree). Thus somewhat independent from Tiebout's original article, the public choice literature suggests that jurisdictional competition not only provides allocative efficiency, but regulatory efficiency as well.

54. William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 213–16 (1997); see also Lowery, *supra* note 36, at 35–36.

55. For instance, Buchanan embraces both Tiebout and a property tax limitation regime like Proposition 13. GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE POWER TO TAX: ANALYTIC FOUNDATIONS OF A FISCAL CONSTITUTION* 197–98 (1980). Clearly, there is a great deal of overlap since both competition and outright limitation control the size of local government. However, as discussed *infra*, a property tax limitation regime inevitably interferes to some extent with the operation of the property tax as a price. Interestingly, in the immediate aftermath of Proposition 13, Buchanan observed an ominous reason for the success of a single-issue proposition only about tax cuts, namely that voters could approve cuts without any corresponding consensus on cutting government services, i.e., on trimming the size of the Leviathan. James M. Buchanan, *The Potential for Taxpayer Revolt in American Democracy*, 59 Soc. Sci. Q. 691, 693–94 (1979). At the level of theory, this suggests the possibility of tax limitation regimes that interfere with the Tiebout dynamic but do not in fact limit the size of government—this observer would suggest that this is in fact an accurate description of many tax limitation regimes.

E. Tiebout and the Constitution

The move from public choice theory, especially its embrace of the Tiebout model, to Madison and constitutional theory, is a small one. As Judge Easterbrook put it, citing to Tiebout explicitly:

Madison's elaboration of the constitutional plan is the best piece of political philosophy penned on this side of the Atlantic. Recognizing the simultaneous terror, inevitability, and desirability of faction, and proposing conquest by division (the strategy of faction itself), is genius. Madison also anticipates, without quite articulating, the point that a plurality of jurisdictions checks the power of faction even at the local level. Although each local government may control immovable assets (principally land), its ability to take any other step is constrained by exit—in other words, by competition with other jurisdictions. A federal republic strengthens this competition by facilitating movement of assets and persons. Public schools may be the government's tools, but you can shop for the government you prefer!⁵⁶

Easterbrook's praise of a uniquely American political philosophy also contains an implicit reference to Gordon Wood's famous argument that the founders specifically designed a post-classical constitution—that is, a constitution that did not rely on the civic virtue of the citizenry.⁵⁷ Indeed, on Easterbrook's gloss, the Constitution is designed to operate through the citizens' exercise of exit, not voice (and certainly not loyalty).

In fact, the Supreme Court's jurisprudence has contributed to the viability of the Tiebout model, and perhaps somewhat consciously so. The power to zone, essential to the Tiebout model, did not receive the Court's blessing until 1926,⁵⁸ and as astute an observer as Cardozo did not believe that approval of the zoning power was a foregone conclusion.⁵⁹ We have already seen that, at

56. Frank H. Easterbrook, *The State of Madison's Vision of the State: A Public Choice Perspective*, 107 HARV. L. REV. 1328, 1333 (1994) (citing Tiebout).

57. J.G.A. Pocock, *THE MACHIAVELLIAN MOMENT* 521–22 (1975) [hereinafter *MACHIAVELLIAN MOMENT*]; GORDON S. WOOD, *THE CREATION OF THE AMERICAN REPUBLIC*, 1776–1787 606–15 (2d ed. 1998).

58. *Vill. of Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926) (upholding zoning generally under the police power).

59. According to Cardozo, the zoning power may well have been struck down by the Court if by the time it reached the Court it had not been operating so widely and successfully. BENJAMIN N. CARDOZO, *THE PARADOXES OF LEGAL SCIENCE* 126 (Columbia Univ. Press 1928).

least to some extent, the Court was moved by proto-Tieboutian arguments to uphold zoning as essential to excluding free-riders. A strong argument was made decades later that there were limits to the zoning power inherent to the federal Constitution, particularly as a result of the Equal Protection Clause—put simply, at the end of the day, there needed to be somewhere for apartment-dwellers to live, parasites or not. These challenges were rejected, with the result that for practical purposes any limits on zoning must be a matter of state law.⁶⁰ Finally, one might have thought that school district lines would not be respected if they were used to recreate a system of segregation that a federal court was trying to combat in a neighboring district, but the Court decided otherwise in *Milliken*.⁶¹ District lines are particularly important to a Tiebout dynamic because they represent the boundaries of the amenity bundle purchased, and so *Milliken* in effect protected purchasers from having their bundle of goods disturbed after having purchased a home.

Perhaps the strongest challenge to the underlying constitutional underpinnings of the Tiebout model involved school financing. It is axiomatic that local governments are mere creations of the state,⁶² and this would suggest that states cannot do indirectly through setting up a certain local government system what they could not do directly.⁶³ That is, a state could not set up a centralized system for providing education where resources diverged wildly between regions; such a scheme would fail even rational basis review.⁶⁴ Why then could a state achieve the same

60. *Vill. of Arlington Heights v. Metro. Hous. Dev. Corp.*, 429 U.S. 252, 264–65 (1977) (upholding local single-residency zoning plan despite racially discriminatory impact); *Warth v. Seldin*, 422 U.S. 490 (1975) (denying standing to nearby residents of a town that was pervasively zoned for large-lot single family residences); *Vill. of Belle Terre v. Boraas*, 416 U.S. 1 (1974) (upholding zoning for “single-family” dwellings).

61. *Milliken v. Bradley*, 418 U.S. 717, 745 (1974) (“[W]ithout an interdistrict violation and interdistrict effect, there is no constitutional wrong calling for an interdistrict remedy.”).

62. *Hunter v. City of Pittsburgh*, 207 U.S. 161, 178 (1907). Just because it is axiomatic does not mean this principle has been consistently applied (or should be); see the discussion of *Barron*, *infra* note 93.

63. See, e.g., *Fort Gratiot Sanitary Landfill, Inc. v. Mich. Dep’t of Natural Res.*, 504 U.S. 353, 361 (1992) (holding that “a State (or one of its political subdivisions) may not avoid the strictures of the Commerce Clause by curtailing the movement of articles of commerce through subdivisions of the State, rather than through the State itself.”).

64. In fact, distinguishing its famous holding in *San Antonio Independent School District v. Rodriguez*, 411 U.S. 1 (1973), the Court indicated just this in *Papasan v. Allain*, 478 U.S. 265 (1986). In *Papasan*, the Court confronted a complicated situation where, in essence, certain lands given to the State of Mississippi by the federal government for the purpose of public education were only generating revenues for the school districts in which these lands happen to have been located. The Court, speaking through Justice White, found that this

result through the means of tying local educational spending to the local property tax? Famously, the Supreme Court in *Rodriguez* held that such a system survived rational basis review, despite the resulting gross disparities in resources.⁶⁵ Although the Court used some general rhetoric of “local control” in explaining what was rational about this system,⁶⁶ it was specifically local control over *revenues* that was at issue and the Court’s decision reflects this.⁶⁷ The issue could not have been local control per se because it is possible to have a centralized (and equalized) school finance regime where local school boards are still responsible for local administration. In many ways, this is the system that has developed in California.⁶⁸ And so in finding the system at issue in *Rodriguez* rational, the Court was apparently accepting as at least rational some of the Tiebout-type reasoning we have already discussed as to the benefits of local control of property taxes in particular.

allocation might fail rational basis review (the case was remanded) and distinguished the situation from that upheld in *Rodriguez* as follows:

This case is therefore very different from *Rodriguez*, where the differential financing available to school districts was traceable to school district funds available from local real estate taxation, not to a state decision to divide state resources unequally among school districts. The rationality of the disparity in *Rodriguez*, therefore, which rested on the fact that funding disparities based on differing local wealth were a necessary adjunct of allowing meaningful local control over school funding, does not settle the constitutionality of disparities alleged in this case, and we differ with the Court of Appeals in this respect.

Papasan, 478 U.S. at 288.

65. *Rodriguez*, 411 U.S. at 40 (“We are asked to condemn the State’s judgment in conferring on political subdivisions the power to tax local property to supply revenues for local interests. In so doing, appellees would have the Court intrude in an area in which it has traditionally deferred to state legislatures. This Court has often admonished against such interferences with the State’s fiscal policies under the Equal Protection Clause . . .”).

66. *See, e.g., id.* at 49–54 (“The persistence of attachment to government at the lowest level where education is concerned reflects the depth of commitment of its supporters. In part, local control means, as Professor Coleman suggests, the freedom to devote more money to the education of one’s children. . . . [A]ny scheme of local taxation—indeed the very existence of identifiable local governmental units—requires the establishment of jurisdictional boundaries that are inevitably arbitrary.”). It is interesting that the Court here acknowledges that, at least as a general matter, district lines are “arbitrary.” It is certainly conceivable that deference to local government boundaries is justified as deference to pre-existing political communities. To some extent, this might have been true and is still true, as even newer communities can assume a meaningful identity. Nevertheless, I think that the Court has wisely recognized that the current convoluted patchwork of overlapping entities cannot be justified in terms of pre-existing (or even current) communal attachments.

67. *See, e.g., id.* at 49–50 (“Equally important, however, is the opportunity [local control] offers for participation in the decisionmaking process that determines how those local tax dollars will be spent.”).

68. *See generally* Eric J. Brunner & Jon Sonstelie, *California’s School Finance Reform: An Experiment in Fiscal Federalism*, in TIEBOUT AT FIFTY, *supra* note 48, at 55.

These cases do not of course prove that Tiebout has been constitutionalized. They do, however, suggest that the rationality of jurisdictional competition has been found to be constitutionally salient.⁶⁹ Indeed, there are authors who make strong arguments

69. I also submit that a grand theory making sense of the Court's position on the role and justification for local government (per Barron) is not possible at this point and so partial explanations will have to do. For the demise of Barron's synthesis, see *infra* note 93. For a particularly disconcerting line of cases, see the role of local governments in the *Fullilove*, *Croson*, *Metro Broadcasting*, *Adarand* line of cases. *Fullilove* upheld an affirmative action program at the federal level, *Fullilove v. Klutznick*, 448 U.S. 448 (1980), while *Croson* invalidated a very similar program at the local level specifically because it was at the local level. Citing *The Federalist No. 10* (James Madison) and Gordon Wood, Justice Scalia explained:

As Justice O'Connor acknowledges, [in her opinion for the majority,] it is one thing to permit racially based conduct by the Federal Government—whose legislative powers concerning matters of race were explicitly enhanced by the Fourteenth Amendment—and quite another to permit it by the precise entities against whose conduct in matters of race that Amendment was specifically directed.

....

A sound distinction between federal and state (or local) action based on race rests not only upon the substance of the Civil War Amendments, but upon social reality and governmental theory. . . . What the record shows, in other words, is that racial discrimination against any group finds a more ready expression at the state and local than at the federal level. To the children of the Founding Fathers, this should come as no surprise. An acute awareness of the heightened danger of oppression from political factions in small, rather than large, political units dates to the very beginning of our national history. As James Madison observed in support of the proposed Constitution's enhancement of national powers

City of Richmond v. J.A. Croson Co., 488 U.S. 469, 521–23 (1989) (Scalia, J., concurring) (citations omitted). This line of reasoning was accepted, it seemed, by a majority of the Court in *Metro Broadcasting* in upholding a different federal affirmative action program. *Metro Broad., Inc. v. F.C.C.*, 497 U.S. 547, 565 (1990) (“[M]uch of the language and reasoning in *Croson* reaffirmed the lesson of *Fullilove* that race-conscious classifications adopted by Congress to address racial and ethnic discrimination are subject to a different standard than such classifications prescribed by state and local governments.”). This distinction between the federal and state governments was then abandoned in *Adarand*. *Adarand Constructors, Inc. v. Peña*, 515 U.S. 200, 252 (1995) (Stevens, J., dissenting) (“Ironically, after all of the time, effort, and paper this Court has expended in differentiating between federal and state affirmative action, the majority today virtually ignores the issue.”). Yet this argument is not yet gone—the Madison-inspired argument about the perils of local decision-making makes another appearance (without Wood and Madison) in the dissent of Justice Scalia in *Romer*, one of the lead cases cited to by Barron for the proposition that local governments are allowed to be out in front in connection with equality. *Romer v. Evans*, 517 U.S. 620, 645–47 (1996) (Scalia, J., dissenting) (“The problem (a problem, that is, for those who wish to retain social disapprobation of homosexuality) is that, because those who engage in homosexual conduct tend to reside in disproportionate numbers in certain communities, . . . have high disposable income, . . . and, of course, care about homosexual-rights issues much more ardently than the public at large” (citations omitted)). There are many other lines of cases suggesting there might be a special role/analysis for local governments (such as involving Section 1983 and voting rights). For instance, local governments have recently been given a privileged status in dormant commerce clause analysis. *United Haulers*

that the Tiebout dynamic should be made *more* salient to constitutional law. Particularly interesting in this regard is Been's argument that the Tiebout dynamic is sufficiently robust that the Court's exactions jurisprudence is misguided precisely because it is unnecessary.⁷⁰ That is, there is no reason for imposing fuzzy legal rules on exactions when the marketplace for government services will police and prevent excessive exactions.⁷¹

III. RECONSIDERING THE TIEBOUT MODEL: THE ROLE OF POLITICS

As should be clear at this point, the Tiebout model is a powerful justification for our current local government system. It offers the efficient allocation of resources and taxation, constrains the size of government, and promises to provide the level of local public goods that people want. As discussed in the previous Section, many leading Supreme Court decisions imply a naïve form of the Tiebout model. Even if they do not, the Court has helped cultivate the preconditions for a functioning Tiebout dynamic and these federal doctrines (and much state law) make the current jurisdictional landscape hard to change. Empirical evidence suggests that the Tiebout dynamic is a fact, and certain theorists plausibly suggest that this fact should further inform the Court's jurisprudence.⁷²

Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 550 U.S. 330 (2007). In 2008, the logic of *United Haulers* was found to apply to the tax exempt municipal bond market. See *Dep't of Revenue of Ky. v. Davis*, 128 S. Ct. 1801, 1810 (2008).

70. Vicki Been, "Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine, 91 COLUM. L. REV. 473 (1991).

71. *Id.* at 527–28 ("Given the availability of numerous communities from which to choose and differences between the public service and tax packages that communities offer, the fact that consumers shop for a public service and tax package is strong evidence supporting the core Tiebout proposition that jurisdictions compete for residents by attempting to offer desirable public service/tax packages."). Interestingly, as recently observed by Schragger, a leading Tiebout scholar, like Fischel, believes that, to the contrary, courts should vigorously enforce the Takings Clause in support of a Tiebout dynamic. Richard C. Schragger, *Cities, Economic Development, and the Free Trade Constitution*, 94 VA. L. REV. 1091, 1149–50 (2008) (construing Been and Fischel, *supra*). This underscores the extent to which our understanding of the empirics of Tiebout dynamics, even if they exist at all, does not at all lead to obvious policy prescriptions and this is another reason not to eschew politics. The focus of this Article, however, is not on the limitations of Tiebout in reality, so much as on acknowledging the limitations of Tiebout even in an ideal situation.

72. As to these proposals, I must demur. First, though there is empirical evidence for the existence of Tiebout dynamics, I am doubtful that these dynamics are of sufficient magnitude to be of constitutional salience. That is, for instance, I do not think that Tiebout is a sufficient constraint on local governments generally to justify that they be governed by different doctrines. Cf. Christopher Serkin, *Local Property Law: Adjusting the Scale of Property Protection*, 107 COLUM. L. REV. 883 (2007). Second, to the extent that sufficient salience could be achieved through encouraging Tiebout, I would not be in favor of such proposals

There is, however, one promise of the Tiebout model that it cannot deliver on, and this is its seeming ability to make distributive choices about local public goods without politics.⁷³ By “political” choices, I mean choices that are motivated by norms outside of the Tiebout model (i.e., outside of allocative efficiency or, relatedly, home value)⁷⁴ and made by a non-market process (i.e., through voice, not exit). There are two related ways in which it could be argued that the Tiebout model dispenses with politics, and both, I will argue, are incorrect.

First, the strong anti-politics view reasons that if jurisdictional competition is robust, then jurisdictions are simply responding to preferences like private actors and, in many cases, *as private actors*, and so there is no need for a political process to determine how much should be spent on local public goods, like schools. In Tiebout’s original article, there is only a city manager looking after preference satisfaction, and if the manager miscalculates, the market mechanism will correct her mistake (most obviously, people will leave). If there is robust competition, even the city manager is largely redundant because developers can essentially build whole new communities from the ground up and the market will decide whether they have been successful.⁷⁵ This vision applies most

without different political choices being made of the sort discussed in this Article both to mitigate the Tiebout dynamic externally and to rechannel it internally.

73. Cf. Dennis Epple & Allan Zelenitz, *The Implications of Competition Among Jurisdictions: Does Tiebout Need Politics?*, 89 J. POL. ECON. 1197, 1198 (1981) (“Tiebout’s argument thus appears to imply that the ballot box is unnecessary, that efficient provision of local public services will arise because residents can vote with their feet.”).

74. In this Article, I use the notion of Kaldor-Hicks efficiency, in which the economic winners could potentially compensate the economic losers using the additional wealth generated by the more efficient rule. Cf. Andrew G. Dietderich, *An Egalitarian’s Market: The Economics of Inclusionary Zoning Reclaimed*, 24 FORDHAM URB. L.J. 23, 25 n.1 (1996) (defining terms, following Posner); see also AM. SOC’Y OF PLANNING OFFICIALS, WINDFALLS FOR WIPEOUTS: LAND VALUE CAPTURE AND COMPENSATION 143–44 (Donald G. Hagman & Dean J. Mischynski eds., 1978) [hereinafter WINDFALLS FOR WIPEOUTS]. Fischel clearly believes the Tiebout model is efficient in this way since, as discussed *infra*, he would transfer resources from winning local jurisdictions to losing ones through a transfer mechanism at some higher level of government.

75. See J. Vernon Henderson, *The Tiebout Model: Bring Back the Entrepreneurs*, 93 J. POL. ECON. 248, 259–60 (1985) (“What determines the allocation of the fixed number of communities between the rich and the poor? Land companies will adjust the land use of their communities until the allocation of rich and poor communities is such that within and across communities the derived demand for land in housing equals supply at equalized land prices. As another example, What happens if there are inefficient land companies? With free entry of entrepreneurs, at the limit inefficient land companies will be bought out and supplanted by efficient ones.”). But see Epple & Zelenitz, *supra* note 73, at 1199, 1216 (“Although increasing the number of jurisdictions reduces each government’s ability to levy taxes in excess of expenditures, we demonstrate that competition among jurisdictions, even with very many jurisdictions, is not sufficient to prevent individual governments from pursuing policies which are not in the interests of their residents. . . . The feature of our model

obviously to areas with the potential for new communities, but it also applies to redevelopment projects within communities. All the city manager and legal background rules have to do is let developers compete with each other and through this competition a rejuvenated downtown will look the way citizen-consumers want it to look.

There is a somewhat less radical argument as to the lack of need for politics in the context of a Tiebout model, which I will call the weak anti-political position. The key reason for the concession that characterizes this position is that the Tiebout model is extreme. For instance, mobility is not costless, and it is not as if a city manager can be easily disciplined by the market, even if it were empirically true that bureaucrats do (and should) act as property-tax maximizers. Thus Fischel incorporates a minimal politics into his model; this reliance on a minimal politics is the weak anti-political position. I say "minimal" politics because Fischel's point is "to show how mercenary concern with property values, especially that of homeowners, motivates citizens to organize and make personal sacrifices for such things as public schools and amenable environments."⁷⁶ Thus the primary concern of his local politics is economic and in the limited sense of increasing home value; this limited politics is what will keep local government on track and, left alone to interact with a Tiebout dynamic, will also attend (for the most part) to other normative concerns because citizens will know they will lose money if they allow their community to deteriorate. It follows from even the weaker anti-political stance I am associating with Fischel that local government rules are primarily of interest to the extent that they do or do not enable competition (and hence efficiency); their distributive consequences are irrelevant (except to the effect that misguided concern with distribution undermines their efficiency).⁷⁷ Such a position seems to underlie

that is primarily responsible for this result is the assumption of fixed jurisdictional boundaries. A government given taxing powers in a jurisdiction with fixed boundaries can exploit the immobility of land and share in the rents accruing to that land."). My argument is, even if a Tiebout model has no need for politics (e.g., because of developers, local government cannot be inefficient for long), the Tiebout model still relies on political decisions (e.g., through selecting rules governing development).

76. FISCHEL, *supra* note 39, at 18; *see also id.* at 96 ("I submit that Tiebout's neglect of local government politics requires only modest amendment of his model. In most local governments one just has to replace Tiebout's invisible municipal managers with the median-voter model. The median voter will want to do most of the same things that an entrepreneurial private manager would want to do.").

77. This result also generally follows for those that believe that local regulations themselves should be left to the local government market and that central governments should focus primarily on ensuring that there is adequate competition at the local level. There is, for instance, a recent thoughtful proposal to allow local governments to compete as to the

the support for the Mello-Roos bond status quo discussed at the beginning of this Article. That is, it is perfectly appropriate to give local governments and developers a new tool to spur development, but highly inappropriate to dictate that such a tool is only to enable smarter development patterns.

I maintain that a robust politics is inherent to the Tiebout model and that even the weaker Fischel-type position is incorrect. Specifically, I will argue that there are two ways in which a more robust politics constrains the Tiebout model, one way I label “external” and one “internal.” By external I mean to indicate the various ways in which creating and sustaining Tiebout-type jurisdictional competition is itself a political choice. I use the adjective “external” because this constraint explicitly evaluates the Tiebout model according to non-Tieboutian values.

The second type of constraint, which is the focus of this Article, I label internal. The internal constraint assumes a functioning Tiebout model, but its existence demonstrates that, nevertheless, within such a model, political choices must be made. At the heart of the internal political constraint is the following argument, emerging from Tiebout’s original conditions for making his model efficient. If the Tiebout model is to operate efficiently, then jurisdictions must achieve economies of scale. Economies of scale dictate that there will only be a certain number of jurisdictions and that certain public goods are likely to be produced together. It is doubtful that anyone gets just the school and parks she wants; we all have to compromise. Of the limited sets of bundles possible given the constraint of economies of scale, there are presumably multiple sets of second-best bundles that are all equally efficient (at least for pragmatic purposes). Choosing among these equally efficient sets must be done on some other basis than efficiency. I argue that one crucial way we make such choices is through our background legal rules.

level of property protection that they will offer. *See* Serkin, *supra* note 72, at 886 (“Creating different local property regimes allows for a new dimension in Tiebout-style sorting. Satisfying individual preferences for property regimes will unlock additional property values as people pay premiums to receive the property protection that they want.”). Serkin only considers the normative implications of opening a new arena for Tiebout competition in passing and concludes that these concerns ought not derail his efficiency-enhancing proposal. *See id.* at 933.

A. Politics as External Constraint

The most straightforward way to see jurisdictional competition as a political choice is to note that one central feature that makes it efficient, namely the fact that the property tax serves as a price for local amenities, also prevents (significant) redistribution at the local level.⁷⁸ Thus advocating a model of jurisdictional competition is likely to freeze in place any distributional inequities without intervention from a higher level of government. There is a further argument that Tiebout competition is very likely to increase the level of inequality between jurisdictions. Round after round of Tiebout competition will likely result in more and more precise sorting in part because people will find others who share ever more precise tastes, but also in part because the more economically homogenous a community becomes, the fewer free-riders there will be. Ever more precise zoning out of free-riders has a likely converse, namely concentrating the “losers” of Tiebout competition. If one assumes an unequal initial distribution of resources and also that this inequality to a considerable degree tracks race, then the seemingly neutral operation of competition will lead to greater and greater segregation by race and class, which is arguably what we have witnessed.⁷⁹ And this is without assuming that many individuals actually have a preference for racial or social exclusivity.

Tiebout advocates, like William Fischel, recognize the power of this external critique and offer the traditional solution. We ought not to abandon the Tiebout model in the face of these problems, says Fischel, but we should instead redistribute from a higher level of government. Fischel specifically proposes a program whereby a state would pay any school district a higher than average lump-sum (a “public school supplement”) for taking on a poor student, thus opening wealthier districts to poorer students because these students would not be free riders.⁸⁰ Fischel labels his prescriptions “tough love” because he recognizes that Tiebout-type localism is being chipped away at, at least partially, as a reasonable response to its shortcomings.⁸¹

78. Cf. Bankman, *supra* note 49, at 784.

79. See Yishai Blank, Brown in *Jerusalem: A Comparative Look on Race and Ethnicity in Public Schools*, 38 URB. LAW. 367 (2006) (applying similar insight to Israel and arguing that jurisdictional competition has increased the gap not only between Israeli Jews and Israeli Arabs, but among Israeli Jews); Richard Thompson Ford, *The Boundaries Of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841 (1994) (demonstrating how Tiebout dynamic overlaid on initial racialized inequality leads to deepening inequality).

80. FISCHEL, *supra* note 39, at 279–81.

81. *Id.* at 288–89.

Thus Tiebout advocates would seem to acknowledge the need to defend the Tiebout model politically in light of some of its likely impacts. Yet following Nagel and Murphy (who themselves follow G.A. Cohen),⁸² how plausible is it to envision homevoters looking after their private interests at the local government level and then voting for necessary redistribution at the state and federal level? More concretely, would Fischel's homevoters agree to his school finance plan? Let us take his proposal to subsidize the school costs of poorer children. Such a program in California would (conservatively) require \$7.5 billion/year or 22% of the current state budget for K-12 education in California.⁸³ And this is assuming 1) that it does not cost more on average to educate an underprivileged child (thereby undermining the value of the subsidy), and that 2) other communities, because of factors like "peer effects," will not refuse to take such children at almost any price.⁸⁴

In addition to its distributive downside, the Tiebout model is not the only way to control the size of government, which leads to the observation that not only must the Tiebout model be protected from majorities alienated by its distributive impacts, but it also has

82. LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 70–73 (2002).

83. In California, "[a]cross all funds, the difference in total expenditures in a district at the 25th percentile of spending and a district at the 75th percentile of student-weighted spending is more than \$3,000 per student." SUSANNA LOEB ET AL., *DISTRICT DOLLARS: PAINTING A PICTURE OF REVENUES AND EXPENDITURES IN CALIFORNIA'S SCHOOL DISTRICTS 1* (2006) (on file with the University of Michigan Journal of Law Reform), available at [http://irepp.stanford.edu/documents/GDF/STUDIES/05-Loeb-SACS/5-Loeb-SACS\(3-07\).pdf](http://irepp.stanford.edu/documents/GDF/STUDIES/05-Loeb-SACS/5-Loeb-SACS(3-07).pdf). There are about six million students in California. Thus, giving a grant to the least privileged 25% of students by student expenditure (i.e., 1,500,000 students) that would bring them to the level of the top 75% (namely \$3,000) would cost \$4.5 billion per year. But just equalizing the spending is not likely to be enough to induce wealthier school districts to accept these students, which is why my rough calculation above is based on a \$5,000/student grant, which required \$7.5 billion/year or 22% of California's total education spending of \$33 billion in 2005–06. LEGISLATIVE ANALYST'S OFFICE, 2006–07: OVERVIEW OF THE GOVERNOR'S BUDGET 9 (2006) (on file with the University of Michigan Journal of Law Reform), available at http://www.lao.ca.gov/2006/budget_ov/2006-07_budget_ov.pdf. About half of California's students are in the free or reduced lunch program. Note that it is already the case that many of the poorest districts spend more on average per pupil, LOEB ET AL., *supra*, at 34–35, and this suggests the limited efficacy of a simple grant. The wealthiest districts in California, which receive very little state aid, spend about 40% (about \$4,000) more per pupil than average and 107% more on capital outlay. *Id.* at 54–55. The differential in capital outlay is partially explained by the rules for public school construction, as discussed *infra*.

84. The existence of peer effects is generally accepted. See, e.g., Wallace E. Oates, *On Local Finance and the Tiebout Model*, 71 AM. ECON. REV. 93, 95–97 (1981). The existence of peer effects creates its own riddles. Suppose, as makes sense and seems to be the case, *see id.*, that stronger students do better when surrounded by only other strong students, but that all students do better still when there is a smattering of strong students dispersed among them. This means that the whole group benefits more from dispersion, but individuals more from homogeneity.

a peculiar relationship with its “friends.”⁸⁵ One leading way of controlling the size of local government, pioneered in California, is simply to cut property taxes permanently and, in particular, to sever the property tax from home value. This is largely what Proposition 13 has done. As Fischel notes, such undermining of the property tax weakens the Tiebout dynamic because it weakens the ability of the property tax to act as a price.⁸⁶ It would be strange to characterize Proposition 13 as a conscious choice by Californians to move away from Tiebout and towards centralization, particularly of education, though that is what has happened. It seems more apt, to the extent that Proposition 13 truly did express a conservative hostility to government, to view Proposition 13 as expressing a hostility to government services, even if provided at an efficient level. After all, a functioning Tiebout dynamic will provide at least the services that people want, but there is no rule that there cannot be a disconnect between what people want and what they are willing to pay for.⁸⁷

85. I am not the only one to note the difference between “fiscal conservatives” (i.e., those who fear Leviathan, such as Buchanan) and those who embrace Tiebout directly (such as Fischel). Cf. Eric J. Brunner & Jon Sonstelie, *California’s School Finance Reform: An Experiment in Fiscal Federalism*, in TIEBOUT AT FIFTY, *supra* note 48, at 55, 88–90 (distinguishing advocates of decentralized government from fiscal conservatives); see also FISCHEL, *supra* note 39, at 108.

86. Fischel explains the turn away from Tiebout as caused by the fact that the California Supreme Court had already undermined Tiebout by mandating school finance equalization. FISCHEL, *supra* note 39, at 111–18. That is, if local property taxes were not going to go towards local schools, then Californians decided that they would simply not pay property taxes. This sweeping hypothesis is controversial and I am convinced goes too far. See Kirk Stark & Jonathan Zasloff, *Tiebout and Tax Revolts: Did Serrano Really Cause Proposition 13?*, 50 UCLA L. REV. 801, 830 (2003) (“On the whole, our swing model suggests that the cause for any voter shift between 1972 and 1978 lies not in school finance reform, but in a combination of the ‘revolt of the haves’ (not defined in terms of property wealth, but rather income) and the problem, well recognized at the time of Prop 13’s passage, of seniors getting priced out of their homes by soaring tax bills.”). But see William A. Fischel, *Did John Serrano Vote for Proposition 13? A Reply to Stark and Zasloff’s “Tiebout and Tax Revolts: Did Serrano Really Cause Proposition 13?”*, 51 UCLA L. REV. 887, 887 (2004) (responding to Stark and Zasloff); see also Isaac Martin, *Does School Finance Litigation Cause Taxpayer Revolt? Serrano and Proposition 13*, 40 LAW & SOC’Y REV. 525 (2006) (critiquing Fischel). There is a large literature trying to explain the advent and persistence of statewide tax limitation regimes that constrain local taxes when local taxes could presumably simply have been controlled by local voters themselves. See generally Jacob L. Vigdor, *Other People’s Taxes: Nonresident Voters and Statewide Limitation of Local Government*, 47 J.L. & ECON. 453 (2004) (surveying explanations, including that local voters do not believe they can control their local governments and that voters are voting for statewide provisions of certain services, but concluding the best explanation, analyzing Massachusetts’s Proposition 2½, is that voters were seeking to limit taxes in other jurisdictions).

87. This arguably explains the advent of “welcome stranger”-type taxation. A related argument, made for instance by Miller, is that Proposition 13 was regressive, allowing wealthier citizens to enjoy valuable property, low taxes and reasonable services while the lower income people essential for providing the services have to make do with inadequate services

It is crucial to note that a very persuasive new book by Isaac Martin on the subject of the property tax revolts of the 1970s concludes that they were largely a progressive phenomenon and that their primary goal was the maintaining of property tax privileges that worked as a kind of social insurance.⁸⁸ That is, according to Martin, property values, particularly for homeowners, were typically assessed at a fraction of their true market value.⁸⁹ In fact, the primary means by which this privilege was applied was through copying the old assessment roll year after year.⁹⁰ This meant that the longer one stayed in one's home, the more valuable the privilege, assuming generally rising property values. This informal privilege was generally not only helpful to the least wealthy homeowners, but helped shield all homeowners from the market. This analysis suggests that 1) at least to the extent that the Tiebout model requires the property tax to reflect market prices, the model has rarely obtained, and 2) voters are rather unlikely to embrace such a model, especially if the way to a Tiebout paradise is through a series of property tax-related income shocks.⁹¹

Yet even if there were a stable political majority prepared to vote to create and sustain the Tiebout model, likely with social insurance, and even including sizable redistribution to the less fortunate, thus mitigating some of the impacts of the model, the Tiebout model would still likely exact a price in terms of other political values. To return to Fischel's proposal, it seems more plausible to envision lots of state and federal dollars being sent to poorer districts than poorer students being sent to wealthier districts. This is especially true if what the Tiebout dynamic has contributed to creating is ever more segregated communities ever farther away from one another.⁹² Possible coercion by federal courts, a stick to go

and high taxes. GARY J. MILLER, *CITIES BY CONTRACT: THE POLITICS OF MUNICIPAL INCORPORATION* 196 (1981). Certainly, this kind of argument is particularly powerful as regards Proposition 218, passed in California in 1996. This proposition dramatically limited the ability of local governments to use assessments, which are local levies (e.g., for road paving) that match benefit to cost and thus are very Tiebout-friendly.

88. ISAAC WILLIAM MARTIN, *THE PERMANENT PROPERTY TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS* (2008).

89. *See id.* at 5–13.

90. *Id.*

91. I discuss these issues in greater detail in Darien Shanske, Book Review, *What the Original Property Tax Revolutionaries Wanted (It is Not What You Think)*, 1 CAL. J. POL. & POL'Y 1 (2009) (reviewing MARTIN, *supra* note 88).

92. This goes to the kind of development encouraged by the Tiebout model, namely sprawl, as Fischel acknowledges. *See* FISCHEL, *supra* note 39, at 270–75. Sprawl can be seen as an external critique of the model to the extent one is valuing the environment and is unhappy with the model's results. Sprawl can also be seen as an internal problem of the model to the extent it represents communities avoiding internalizing their true impact, and thus creating an inefficiency.

along with the carrot (i.e., money) provided by the central governments, is largely barred by *Milliken* (ban on inter-district remedies) and even *intra*-district remedies that take into account race are now barred by *Parents Involved in Community Schools v. Seattle School Dist. No. 1*.⁹³ It is precisely because *ex post* manipulation of communities is so difficult that I will argue in the following Section that we must pay special attention to the incentives that are set up *ex ante*.

B. Politics as Internal Constraint

We will elaborate and demonstrate the extent to which the Tiebout model is constrained internally through political decisions by starting with Tiebout's original assumptions:

93. 551 U.S. 701 (2007). *Parents Involved*, though largely driven by its interpretation of the Fourteenth Amendment, is also a local government decision to the extent that both sides appeal to different visions of local governments and the Court's prior jurisprudence. Compare *id.* at 782 n.30 (Thomas, J., concurring) ("Unlike the dissenters, I am unwilling to delegate my constitutional responsibilities to local school boards and allow them to experiment with race-based decisionmaking on the assumption that their intentions will forever remain as good as Justice Breyer's. . . . Indeed, the racial theories endorsed by the Seattle school board should cause the dissenters to question whether local school boards should be entrusted with the power to make decisions on the basis of race."), with *id.* at 866 (Breyer, J., dissenting) ("And what of respect for democratic local decisionmaking by States and school boards? For several decades this Court has rested its public school decisions upon *Swann*'s basic view that the Constitution grants local school districts a significant degree of leeway where the inclusive use of race-conscious criteria is at issue. Now localities will have to cope with the difficult problems they face (including resegregation) deprived of one means they may find necessary."). Another way to see the local government aspect of this decision is to note that in this decision the Court has implicitly rejected the ingenious (and appealing) argument of David Barron that the Court's earlier local government jurisprudence can be understood as preserving a space for local governments to go *beyond* the judiciary in enforcement of constitutional norms and most especially equality norms. David J. Barron, *The Promise of Cooley's City: Traces of Local Constitutionalism*, 147 U. PA. L. REV. 487, 571 (1999) ("Considered in light of Cooley's structural defense of local constitutionalism, and read in conjunction with the localist turn that *Milliken* took, *Seattle School District* may be understood to rest on a defense of local constitutionalism. The case suggests that, as a matter of federal constitutional structure, states may not preclude their local political institutions from promoting a norm of constitutional equality that lies beyond direct judicial enforcement. Such a reading takes *Milliken*'s respect for localism seriously. It reads that respect to rest on the premise that broad, local remedial discretion is a precondition for federal judicial restraint in the area of school desegregation."). Of course, in rejecting Barron's synthesis, this leaves the obvious tension between cases like the first *Seattle School District* case cited above and *Romer v. Evans*, 517 U.S. 620 (1996), on the one hand, which seem to rely on some residual constitutional import for local government, and cases like *Parents Involved*, which grants local governments no special role in advancing equality.

1. Consumer-voters are fully mobile and will move to the community where their preference patterns, which are set,⁹⁴ are best satisfied.
2. Consumer-voters are assumed to have full knowledge of differences among revenue and expenditure patterns and to react to these differences.
3. There are a large number of communities in which the consumer-voters may choose to live.
4. Restrictions due to employment opportunities are not considered. It may be assumed that all persons are living on dividend income.
5. The public services supplied exhibit no external economies or diseconomies between communities. . . .
6. For every pattern of community services set by, say, a city manager who follows the preferences of the older residents of the community, there is an optimal community size. . . .
7. [C]ommunities below the optimum seek to attract new residents to lower average costs. Those above optimum size do just the opposite. Those at an optimum try to keep their populations constant.⁹⁵

We can understand the internal political constraint as operating for one of two reasons. The Tiebout model is constrained by politics both because 1) its extreme assumptions do not obtain, and because 2) even if a full-blown Tiebout model were to exist, politics would still be necessary. In terms of the assumptions of the model, the internal political constraint exists because, for instance, most people do not live off of dividend income and mobility is costly. These two facts mean that people are likely to live near their jobs and are likely to put up with a lot of disappointing amenities once they have moved to a given location. Because of such factors, there are going to be a lot of dissatisfied preferences, especially in jurisdictions that have special locational virtues. Given the likelihood of many equally *inefficient* outcomes as concerns jurisdictional organization, some norms other than simply the satisfaction of preferences are going to be relevant in designing background rules

94. Note that just as local revenue patterns cannot change, neither can voter preferences—education, development, whimsy or simple instability of preferences (per the recent behavioral finance literature) are banished.

95. Tiebout, *supra* note 29, at 419.

that will influence the creation and nature of jurisdictions that we are likely to be stuck with for a long time, even though inefficient.

This conclusion also arises from the nature of a fully functioning Tiebout model. This is an especially important conclusion because it indicates that even a maximally efficient Tiebout model contains normative decisions, and, as noted above, there are a number of prominent theorists who plausibly argue that jurisdictional competition has been empirically proven to a considerable degree.

The bundling of amenities is a reasonable solution to the problem of economies of scale, and economies of scale are essential if a Tiebout model is to operate efficiently.⁹⁶ It makes sense, for instance, to bundle schools and parks, fire and police services, various kinds of utility services, etc.⁹⁷ Even to the extent that local public goods do not enjoy economies of scale when produced together, the limited nature of space dictates bundling.⁹⁸ That is, even though building a school might not contribute any economies of scale to building a fire station, if several thousand people have agreed on a school, then they are going to have to agree on fire protection as well. However, even assuming I have found several thousand relatively like-minded people as concerns schooling, the likelihood of that consensus carrying over equally into fire protection, zoning, etc. seems remote. Therefore, from within even a fully functioning Tiebout dynamic, everyone must make compromises. In a top-down model of goods provision, variety is constrained by the central authorities and whatever decision method they use. The Tiebout model likely offers more choices,

96. I am focusing on the requirement of achieving scale as imposing some necessary dissatisfaction of preferences, but, as Tiebout observed from the beginning, there are also *diminishing* returns as concerns local public goods. That is, even though I could pay the price to live in my desired school district, it may already be optimally sized and so I cannot enter it, or, alternatively, everyone suffers a little to the extent that I am allowed to enter because the local public good is being over-utilized. Cf. Yoo, *supra* note 27, at 676.

97. Interestingly, in one of his original articles on public goods, Samuelson compared the challenge they posed to “the case [in private economics] of a bilateral-monopoly supplier of joint products.” Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STAT. 350, 355 (1955). A “joint product” is one that shares some significant portion of its production cost with another, which would seem to be an accurate description of the relation of many local public goods.

98. Richard T. Ford, *Law's Territory (A History of Jurisdiction)*, 97 MICH. L. REV. 843, 844 (1999) (“I cannot live in San Francisco while paying Los Angeles taxes and receiving Los Angeles's package of services, nor can I pick and choose among the San Francisco services I wish to receive and pay for. While economic markets generally resist bundling, the jurisdictional ‘market’ always bundles.”). See generally Lee Ann Fennell, *Exclusion's Attraction: Land Use Controls in Tieboutian Perspective*, in TIEBOUT AT FIFTY, *supra* note 48, at 163–98 (developing the many attributes in the typical bundle purchased by a homeowner, including those that go beyond local public goods, and thus complicate the Tiebout model, such as social status).

and, at any rate, choices seemingly better calibrated to what citizen-consumers want, but these choices are constrained by what the market can produce efficiently (that is, if the Tiebout model is to be efficient).

Economies of scale, and in particular the phenomenon of bundling, indicate that there will only be a limited number of communities possible in a Tiebout model. In addition, efficiency will require that the jurisdictions be large enough to contain their externalities, which is another limit on the number of jurisdictions. Again, internalizing externalities will also be an impetus for bundling since a properly sized fire protection district will be sufficiently large to require parks, police, etc. In fact, it seems likely that optimally-sized districts for different services will be different sizes, thus creating still more flexibility. That is, suppose that a properly sized fire district is much larger than a properly sized school district—if this is so, then each fire district will represent a compromise reached by the inhabitants of many school districts, and there can be many different sets of school districts within, or partially within, a fire district. Again, given the necessity that all citizen-consumers compromise their preferences to some extent, it seems reasonable to surmise that there are multiple sets of competing jurisdictions that are equally efficient for pragmatic policy purposes.⁹⁹ The set that actually emerges in the world will be partially the result of political choices as to legal background rules.

99. There is a large literature, associated with behavioral finance, which indicates the difficulty with trying to create a preference calculus to try to distinguish among preferences. For an extraordinary survey of the problems, see Mark Kelman, *Hedonic Psychology, Political Theory, and Law: Is Welfarism Possible?*, 52 *BUFF. L. REV.* 1 (2004). Kelman's central claim is that all purportedly neutral tests of well-being smuggle in at least a weak form of perfectionism, such as that only more thoughtful preferences really count. *Id.* at 81–83. For the purposes of this Article, deciding which preferences are worth more is tantamount to making a political decision and so, if Kelman is correct (as I think he is), then deferring to a precise preference-calculator to maximize efficiency in the local government market is just to inject political preferences into the mechanism, and not to avoid politics. It is also worth observing just how incredibly complicated it would be to arrive at any sensible conclusion on preference maximization except in broad strokes. Consider, for instance, the famous example of framing effects. As Kelman puts it: “[S]tudents at a given level of performance have higher levels of self-esteem at low-quality schools and citizens in more egalitarian communities report higher levels of well-being than those with the same income in less egalitarian settings.” *Id.* at 25. Consider this finding concerning student happiness with the finding, noted *supra*, that more homogenous settings are better for stronger students, at least academically, and presumably precisely because they are pushed forward by competition. There are also very relevant problems with temporal instability, which one presumes is only more severe in considering preferences in the context of a home one might own for decades. *See, e.g., id.* at 79 (“[I]f students are asked to pick what snack they will eat in each class over the next three weeks, they are more likely to choose different snacks for each week’s class than if they are asked to choose the snack for each day at the beginning of that day’s class.”). *See*

For example, I may want a very specialized school for my child, focused on the visual arts, and be generally (and idiosyncratically) hostile to parks (I have allergies). I will not only probably have to compromise as to the school (say a general arts charter school), but also as to the parks (there will be some, maybe very many). A school district with an arts charter school and lots of parks might well also have large-lot zoning, so that I may pay for more house than I would ideally want in order to live within a community that only approximates what I would most prefer in terms of schools and parks.¹⁰⁰ It is far from obvious that there would be any efficiency loss if I sent my child to a strong urban public school with a great visual arts program, had to pay for fewer parks, and lived in an apartment a bit smaller than I would ideally want. Which compromise I will choose will to some extent be determined by what

generally Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1075–1126 (2000).

The argument here that only a certain level of precision is possible can also be expressed in terms of property values (as expressions of preference): there are multiple sets of second-best jurisdictions that all have the same total property value. In one set, characterized by deep economic segregation, there are one hundred \$1,000,000 homes and one thousand \$100,000 homes. There can also be fifty \$500,000 homes, one hundred \$200,000 homes, and 950 \$135,000 homes, which have the same total value (about \$200,000,000). Such an alternative makes sense if one supposes that there are a host of unsatisfied preferences. For instance, suppose that about half of the people with \$1,000,000 homes would prefer a less expensive home and about fifty people in \$100,000 homes would prefer (and can afford) a more expensive home, but for a variety of reasons found the \$1,000,000 homes unobtainable or undesirable. One can imagine a path dependent explanation for this first scenario—say a 100 home enclave had long ago seceded from a larger jurisdiction, cannot be reannexed and has protected its exclusivity with exclusionary zoning. A more integrated development scheme allows for different preferences to be satisfied (and frustrated), lowering the value of the most expensive homes, while increasing the value of the least expensive ones (presumably because they would have greater access to services at a lower price).

100. Astute observers have suggested to me that the Tiebout model itself really amounts to a kind of social insurance (which makes Martin's observation on property tax privilege tantamount to a demonstration that individuals want insurance on their insurance). At least for the players in the game with a certain amount of resources (ability to pay the price of a policy), the Tiebout model assures that one will at least be able to live in a community that is not the worst imaginable, even as it is also unlikely that one will get to live in one's ideal community. From this perspective, the external political constraint becomes the question of how much it is worth to pay for this kind of insurance in terms of competing values. The internal political constraint gets into the details of the coverage. There are lots of second-best solutions that our Tiebout-policy could provide. Currently, it would seem that our background rules select for more segregation than most would ideally want; we could instead have background rules that tended to lead to more diversity than most would ideally want, and, according to at least some norms external to the Tiebout model, it might be preferable to err on the side of diversity versus exclusion. See, e.g., Robert C. Ellickson, *Commentary, The Puzzle of the Optimal Social Composition of Neighborhoods*, in TIEBOUT AT FIFTY, *supra* note 48, at 199–209 (summarizing and seemingly agreeing with literature that has found suboptimal level of diversity in current communities and acknowledging that even more diversity might be desired if made possible to the extent that fear of diversity is based on ignorance).

set of jurisdictions the legal rules will have a tendency to produce. Since, by hypothesis, these different sets are all equally efficient, the choice between these sets cannot be made on efficiency grounds. Put another way, jurisdictional competition, must, by definition, occur between second-best jurisdictions, and there are many sets of second-best jurisdictions to choose from and we do choose, partially by means of our legal background rules.¹⁰¹ It is this decision between sets of jurisdictions that I am calling the internal political constraint on the Tiebout model.¹⁰²

A fairly straightforward example of the internal constraint is provided by differing rules for annexation and secession. Speaking generally, in the nineteenth century it was harder for a community to secede and easier for a smaller community to be annexed by a larger one.¹⁰³ Such rules contributed to the growth of enormous cities. In Tiebout terms, such rules frustrated the desires of those who would have preferred to live in separate, more homogenous jurisdictions and enabled those who preferred larger, more diverse cities. It may be that those rules excessively favored those who

101. These rules are likely to be a product of state law, but can also be a matter of federal law (e.g., the federal tax exemption) or local law (e.g., a zoning ordinance). Even as to higher level law imposed on local governments, there are different ways for local governments to compete within these laws (e.g., what kind of exactions to require or projects to finance), though my emphasis is on the laws themselves because they are more powerful and more illustrative.

102. My point is similar to, but distinct from, that made by Fennell in connection with exclusionary zoning: "Coercive governmental action in the form of land use controls structures Tiebout-style choice; matters are not simply left up to the market." Fennell, *supra* note 98, at 180 (citations omitted). My point is similar because we both emphasize underlying political decisions that structure the Tiebout dynamic, with Fennell emphasizing rules involving exclusionary zoning (I will emphasize financing tools). Yet as I understand Fennell, her emphasis is on the fact that exclusionary zoning undermines the normative appeal of Tiebout because the jurisdictional map that results from jurisdictional competition locks out certain consumers. Strictly speaking, the Tiebout model, in its simplicity and brutality, is supposed to bar consumers from amenities they cannot afford. On this ground, one can critique the model externally, but I believe instead that Fennell's (very plausible) contention is that the limits of the model (such as the import of living near where one works in the real world, concerns over peer effects and social status) has led to *excessive* bundling, i.e., to the underproduction of sets of bundles that would be efficient. See, e.g., Dietderich, *supra* note 74, at 32 (arguing that exclusionary zoning, through, for instance, forcing me to consume more house than I want, causes inefficiencies because there is a better use for that extra land); Yoo, *supra* note 27, at 642 (noting that the provision of impure public goods, such as local public goods, can range from efficient to market failure). My primary argument is one step before that of Fennell. That is, even before arguing that we have structured the Tiebout dynamic to reach inefficient outcomes, we should first acknowledge that even if we have structured the Tiebout dynamic to reach an efficient outcome, it was one of many, and we can evaluate the choices we made to reach this particular outcome normatively.

103. See Briffault, *supra* note 48, at 357–58 (following Kenneth Jackson). Note that the rules for incorporation were often permissive in the nineteenth century and that there was already a great deal of political fragmentation. See JON C. TEAFORD, CITY AND SUBURB: THE POLITICAL FRAGMENTATION OF METROPOLITAN AMERICA, 1850–1970 5–31 (1979).

preferred large cities, meaning that those rules actually led to a less efficient set of jurisdictions than was possible. But it could also be the case that such rules simply favored one equally efficient set of jurisdictions, namely one where those with tastes for diversity were more often satisfied relative to those with a taste for exclusion. Sometime this century these default rules switched. It is now easier for a community to secede and harder for it to be annexed. Obviously, this enables those with preferences for relative segregation and, again, this is not necessarily less efficient.¹⁰⁴

The switch in annexation/secession default rules was only a small part of the explosion of the American suburbs and this switch was arguably more an effect than a cause. Changes in society and especially in technology (such as the advent of the car and the interstate) were arguably far more important. Nevertheless, the pro-suburban secession rules were part of a larger package of legal changes that enabled this pattern of development.¹⁰⁵ We have already discussed zoning. Without the power to zone out or at least limit free-riders, the power to secede would have been much less appealing. And it is important to note that the power to zone is not an on-off switch; there is a continuum and there can be different zoning rules with different impacts. The most famous example of a zoning rule that is not all or nothing is the rule crafted by the New Jersey Supreme Court in its central *Mt. Laurel* decision. The rule the court crafted was:

As a developing municipality, Mount Laurel must, by its land use regulations, make realistically possible the opportunity for an appropriate variety and choice of housing for all categories of people who may desire to live there, of course including those of low and moderate income. It must permit multifamily housing, without bedroom or similar restrictions, as well as small dwellings on very small lots, low cost housing of other types and, in general, high density zoning, without artificial and unjustifiable minimum requirements as to lot size, build-

104. There are other ways in which the details of annexation/secession rules shape the local government landscape with dramatic distributional consequences. More flexible secession rules combined with more rigid annexation rules may have allowed more wealthy areas to secede with their valuable tax base, but the essentially voluntary nature of annexation has also allowed both cities and suburbs to avoid annexing poor, often racially-identifiable, communities on their outskirts. See Michelle Wilde Anderson, *Cities Inside Out: Race, Poverty, and Exclusion at the Urban Fringe*, 55 UCLA L. REV. 1095 (2008). Much like the *Mt. Laurel* zoning rule discussed below, there is no *a priori* reason why an annexation rule could forbid such cherry-picking, say through a strong state commission empowered to mandate fair division of the tax base.

105. See generally TEAFORD, *supra* note 103, at 76–104.

ing size and the like, to meet the full panoply of these needs. Certainly when a municipality zones for industry and commerce for local tax benefit purposes, it without question must zone to permit adequate housing within the means of the employees involved in such uses. (If planned unit developments are authorized, one would assume that each must include a reasonable amount of low and moderate income housing in its residential “mix,” unless opportunity for such housing has already been realistically provided for elsewhere in the municipality.) The amount of land removed from residential use by allocation to industrial and commercial purposes must be reasonably related to the present and future potential for such purposes. In other words, such municipalities must zone primarily for the living welfare of people and not for the benefit of the local tax rate.¹⁰⁶

One interpretation of this rule is that the New Jersey Supreme Court prohibited excessive exclusionary zoning schemes because they in effect created externalities in neighboring jurisdictions—exclusionary zoning had actually created inefficiencies. This passage can also be interpreted as arguing that, as a matter of state law and its concern for the general welfare, the set of jurisdictions enabled by zoning should be different (i.e., broader) than the one that has resulted from strong exclusionary zoning. This alternative set, characterized by more mixed and diverse communities and created by a zoning rule mandating some diversity in allowed uses, is not necessarily less efficient, but it does likely result in different amenity bundles being produced and thus different preferences being satisfied. It is choosing strong exclusionary zoning over the *Mt. Laurel* rule that represents a political decision, even assuming that strong exclusionary zoning is neither more nor less efficient.¹⁰⁷

106. *S. Burlington County N.A.A.C.P. v. Twp. of Mt. Laurel*, 336 A.2d 713, 731–32 (N.J. 1975).

107. *Cf.* Dietderich, *supra* note 74, at 41 (“[I]nclusionary zoning schemes are not ‘government spending programs.’ The peculiar genius of inclusionary zoning is that the government can change the stock of affordable housing and redistribute the wealth of neighborhoods merely by manipulating the background rules of property. A vast inclusionary program need not spend a public dime.”). *But see* Benjamin Powell & Edward Stringham, “*The Economics of Inclusionary Zoning Reclaimed: How Effective are Price Controls?*,” 33 FLA. ST. U. L. REV. 471, 499 (2005) (reiterating the traditional argument that inclusionary zoning functions like a tax and depresses the supply of housing and arguing for limiting exclusionary zoning directly to increase housing supply). Though I agree with his critics that Dietderich went too far in his enthusiasm for inclusionary zoning (it may not be that effective and is not costless), I believe that his basic insight about the background rules is correct, as even the traditional economists who critique Dietderich look to exclusionary zoning rules themselves as central to the affordable housing crisis.

An additional celebrated means for using legal technology to enable more exclusionary sets of jurisdictions is the “Lakewood Plan.” One reason wealthier enclaves had once agreed to annexation by larger jurisdictions was that, however expensive the larger municipality’s taxes might be, these taxes would still be less than it would cost the smaller enclave to provide its own services, particularly those like water that involved huge economies of scale. To some extent, technology drove down some of these costs and enabled the explosion of suburbs in the 1950s. But it was also a legal innovation, namely the ability of jurisdictions to contract with each other to provide services.¹⁰⁸ Arguably, these changes just required local insight and political will—all the new city had to do was contract with the county to provide the same services the county used to provide when the new city was just a piece of unincorporated county. Still, such contracting could have been forbidden by state law as undermining the connection between politics, taxes and government services. Furthermore, in many cases, new municipalities needed to do more than enter into contracts with counties, but needed to take advantage of the large and growing bestiary of special districts and authorities that state law made available. Thus many such cities could work together and form a water authority that would have the power to issue bonds secured by water charges. The ability to form such an authority, much less the authority’s ability to issue bonds (generally double tax-exempt), was not fore-ordained.

One underlying characteristic of the rules I have so far discussed as examples is that they are generally most important when communities are started. It is hard to change facts on the ground pragmatically and legally. In fact, many of these “startup rules”

108. Also, in California, the advent of a statewide sales tax distributed (in part) to the locality where the transaction occurred enabled small jurisdictions to generate revenue to pay for their service contracts without raising property taxes or imposing a sales tax that would put them at a disadvantage relative to other jurisdictions. MILLER, *supra* note 87, at 21 (the locus classicus on the Lakewood Plan). The role of the sales tax in this context is an example of a contingent financing rule that has had important effects on the local government landscape and represents a political decision to the extent that the Tiebout model does not require a sales tax of this sort. There could be no sales tax, only a state sales tax, a regional sales tax or local jurisdictions could decide the costs and benefits of imposing a local sales tax on their own. If the rule were that each jurisdiction was on its own, then, as suggested by Miller, this would have discouraged the creation of new jurisdictions at the margin because they would have been more expensive to create. That is, they would have required either higher property taxes or sales taxes that were inefficient to some extent because the higher sales taxes also drove away business to neighboring jurisdictions without the sales tax (or a lower sales tax). To the extent the sales tax in the typical Lakewood incorporation was being paid by residents of neighboring jurisdictions, then these neighboring jurisdictions were subsidizing the secession of key components of the regional tax base.

have received considerable critical attention already, though not necessarily in the manner they are treated here. In the Section that follows, I will focus on a type of rule that has gotten relatively little attention: “bundling rules.”

1. Bundling Rules

As discussed above, the requirement of communities of optimal size, or at least approaching optimal size, mandates the bundling of amenities. A straightforward bundling rule would be the following: the state will fund the building of a park next to every new elementary school that a community builds. There could also be regulatory bundling rules—say, requiring a certain level and type of fire protection based on some formula that took into account both the number of people and their relative dispersion.

Bundling rules relating to schools are particularly important, especially given precedents like *Milliken* and *Parents Involved*¹⁰⁹ that limit *ex post* remedies once a development pattern is in place. One can imagine all kinds of rules regarding the building or rebuilding of schools. There could be a seemingly neutral rule that tax-exempt bonds for school facilities require approval by a two-thirds majority of voters.¹¹⁰ This rule is not neutral to the extent that some communities will have an easier time using this mechanism to raise money that is subsidized by the federal and state governments

109. Cf. *Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1*, 551 U.S. 701, 788 (2007) (Kennedy, J., concurring) (“School boards may pursue the goal of bringing together students of diverse backgrounds and races through other means, *including strategic site selection of new schools*; drawing attendance zones with general recognition of the demographics of neighborhoods; allocating resources for special programs; recruiting students and faculty in a targeted fashion; and tracking enrollments, performance, and other statistics by race.” (emphasis added)).

110. See, e.g., CAL. CONST. art. 13A, § (1)(b)(2); CAL. EDUC. CODE § 15124 (2002). In 2000, the voters of California approved Proposition 39, which lowered the voting requirement for school bonds to 55% if certain conditions are met. Some of these conditions, such as accountability and audit requirements, are not problematic. CAL. CONST. art. 13A, § (1)(b)(3). Some are more so, and in particular that the amount that these bonds can increase the tax rate is capped at \$30/\$100,000 of assessed value (per election), which means, in effect, that the amount of revenue that can be raised by a school district is determined by its property wealth regardless of whether or not 55% of the voters have approved the measure. CAL. EDUC. CODE § 15268. Put another way, a poorer district may simply be unable to take advantage of the lower threshold for many projects. This rule reflects a choice about how easy it will be for various communities to fund new schools. Though the examples that follow will focus on California because it is the jurisdiction I know best, the mechanisms at issue—school bonds, developer fees, assessment districts, even Mello-Roos bonds—are common to most every state. See generally Jeffrey I. Chapman, *The Fiscalization of Land Use: The Increasing Role of Innovative Revenue Raising Instruments to Finance Public Infrastructure*, 12 PUB. WORKS MGMT. & POL’Y 551 (2008).

(because the average parcel of land is worth more). This rule is not necessarily inefficient, but it likely increases bundling of new school construction with property tax wealth.¹¹¹ There could just as easily be a rule lowering the voting requirement in property tax poor areas, or, what is likely much the same, promising state matching funds to such areas if they approve bond measures, thus distributing the federal subsidy differently.¹¹² Deciding which rule to have is a decision about the volume and distribution of local public goods, and this decision is not made automatically by jurisdictional competition.

2. School Building Options and a Return to the Example of Serrano

In order to illustrate how obscure financing rules work to enable the creation of certain bundles of goods, I will return to the example with which we began, the golf-course centered gated community called Serrano.¹¹³ Again, for our purposes, what is essential is that Serrano is isolated from public transportation and features large-lot zoning, a golf course, and highly segregated schools largely financed through the issuance of Mello-Roos bonds. These bonds are double-tax exempt and developers can easily use them to build schools in new communities. This is in contrast to the usual rules governing school bonds, which require a two-thirds majority in an existing community. Mello-Roos bonds are a method of bundling schools not only with new development, and especially large-lot development (which is better able to afford the additional tax levy), but also with exclusionary amenities, such as golf courses.

To the extent that Serrano represents the kind of increased segregation and homogenization inherent to the Tiebout dynamic as citizen-consumers sort themselves ever more precisely, then

111. Importantly, the California Supreme Court struck down such supermajority rules on (federal) equal protection grounds, only to be overruled by the United States Supreme Court. See *Westbrook v. Mihaly*, 471 P.2d 487 (Cal. 1970), *vacated*, 403 U.S. 915 (1971), *re-manded for reconsideration in the light of* *Gordon v. Lance*, 403 U.S. 1 (1971). There are several points to be noted. First, the California Supreme Court's opinion contains an insightful analysis of the historical provenance of these supermajority requirements. Second, neither court addresses the issue that the supermajority rule in question does not just trigger the spending of funds from the community doing the voting, but also triggers subsidies from higher levels of government—at least from a policy perspective, this would seem to be highly relevant. Third, this is yet another way in which decisions of the Supreme Court have been essential in forming the local government landscape.

112. This would essentially be a form of district power equalization which is in use to some extent in several states, including, arguably, California.

113. See *supra* Part I.A.

Serrano illustrates the external political constraint because it demonstrates the normative costs we incur through embracing the Tiebout model. If we are unhappy with this pattern of development (as I am), then norms outside of the Tiebout model likely supply the grounds of the critique.¹¹⁴ For present purposes, however, I wish to emphasize the internal political constraint: seemingly minor but necessary legal background rules channel the type of bundling that occurs and hence configure the local government landscape, with significant distributive impact.

The first way that the relative availability of Mello-Roos bonds affects a distributive outcome is through their interaction with the federal tax system.¹¹⁵ Mello-Roos bond financing for a school in a development like Serrano only became possible in 1982. Without this mechanism, the only way for a developer to build a school before people moved into a development would be for the developer to pay for it herself through development impact fees or a development agreement.¹¹⁶ Development impact fees are levied at the time a building permit is issued.¹¹⁷ Since the developer would have to pay these fees upfront, they would be financed at the developer's cost of capital, which is not a tax-exempt rate.¹¹⁸ To the extent that this additional cost would have made some developments too

114. By norms outside of Tiebout, I mean norms like diversity, fairness, and environmental preservation. As noted before, it is very likely that this type of development has been subsidized to the point where it actually imposes efficiency losses as well.

115. I focus here on the federal tax exemption. Similar arguments can be made in terms of the state tax exemption and the federal deduction for state and local taxes. It should be observed that it is well known that the federal tax subsidy costs the federal government more in taxes given up than the state and local governments benefit from lower interest payments. See JOINT COMM. ON TAXATION, PRESENT LAW AND ISSUES RELATED TO INFRASTRUCTURE FINANCE 26–27 (2008). The inefficiency of the exemption makes it all the more important that it at least be well-targeted.

116. See WINDFALLS FOR WIPEOUTS, *supra* note 74, at 115, 136 (noting upfront financing is often a major challenge for developers).

117. See, e.g., CAL. GOV'T CODE §§ 66000–66009 (2009). The details of the developer fee law also contains important distributive decisions. For instance, the level of school fees in California is generally capped, which means that, without the use of some expedient such as Mello-Roos, the school district will not necessarily be made whole by a new development. See CAL. GOV'T CODE § 65995. Furthermore, it is permissible and common for developer fees themselves to be financed by Mello-Roos taxes.

118. Developers certainly argue, publicly at least, that the use of tax-exempt bonds creates a savings that they can (at least in part) pass on to new homeowners. As I argued in an earlier paper, this is unlikely to be consistently true given the expense of Mello-Roos financings—the tax-exemption only serves to consistently mask this expense. See, e.g., Shanske, *supra* note 8, at 758. However, the lack of savings does not indicate that there is no distributive decision being made. I argued that developers use these bonds not because of the savings but because the taxes that are used to repay these bonds are not fully capitalized into home prices by buyers. If this is correct, then Mello-Roos taxes allow developers to externalize their costs to the significant extent that the tax is not capitalized into the home price by homebuyers.

expensive, or a development without a school unmarketable, then the availability of the federal tax exemption in connection with bonds of this sort shifts the set of amenity bundles to be produced towards greater relative exclusion. It should be noted that this is not just a matter of state law creating this financing mechanism, as the federal government, certainly by statute and arguably by regulation, could forbid the use of tax-exempt funds for projects like this.

Another way of illustrating the political choice being made jointly by local, state and federal governments is to contrast Mello-Roos bonds with assessment bonds, a financing device common since the nineteenth century.¹¹⁹ An assessment is a levy on a piece of land that is proportionate to the benefit that that piece of land receives.¹²⁰ The paradigm project is an assessment levied to pave a road—one pays only one's share of the road project's cost, perhaps in proportion to how much of the road fronts your property. Assessments act as a price for a good or service and are therefore consistent with the Tiebout model. Assessments can be used to pay for the infrastructure of new development, much like a Mello-Roos tax. Thus, to the extent that one wanted to enable some development beyond that provided by impact fees, assessment law would have been adequate to provide both a tax-exemption and a means for developers to pass on the upfront costs.¹²¹ However, precisely because assessment law requires a tight nexus between cost and benefit, assessments cannot generally be used to build schools.

Furthermore, assessment law itself need not be taken as a given. In 1980, Donald Shoup proposed a modified version of assessment financing where the assessment is only due when a home is sold, thus obviating the cash flow problems caused by assessments.¹²² The cash flow problem is caused by the fact that just because one's

119. See generally Stephen Diamond, *The Death and Transfiguration of Benefit Taxation: Special Assessments in Nineteenth-Century America*, 12 J. LEGAL STUD. 201, 202 (1983).

120. See, e.g., *Knox v. City of Orland*, 841 P.2d 144, 149–50 (Cal. 1992) (traditional definition).

121. I have started to research the history of assessment districts. My preliminary research indicates that they are no more expensive than Mello-Roos districts to set up and can be used for similarly exclusive projects. See, e.g., County of Orange, Cal., Official Statement Newport Coast Phase IV Assessment District No. 01-1, at 16 (July 17, 2003) (assessment district financing for 168 townhouses in Newport Beach California, with prices starting from the high \$500,000s in a gated community with a clubhouse, lap pool, and spa). However, assessment districts are used far less often than Mello-Roos, and I suspect one key reason is the greater flexibility offered by Mello-Roos.

122. Donald C. Shoup, *Financing Public Investment by Deferred Special Assessment*, 33 NAT'L TAX J. 413, 413–14 (1980). An additional intriguing possibility is to broaden the possible use of assessments, for example for regional transportation improvements. See WINDFALLS FOR WIPEOUTS, *supra* note 74, at 322 (proposing assessments be used to finance “nonlocal improvements”). Combining these two innovations, i.e., allowing deferred assessments for larger projects, would create a potent pro-Tiebout means of funding infrastructure.

home has increased in value thanks to the assessment does not mean that one has more income in any given year to pay the assessment.¹²³ Such a deferral structure could also be used to mitigate the analogous cash flow problem caused by property taxes in general.¹²⁴ As under current law, prepayments would be allowed of assessments, as would paying one's assessment according to an amortization schedule.¹²⁵ It could be objected that such a structure is not financially viable since such deferred assessments would need to be used in most cases to secure bonds that will finance the improvement in the first place, but without a predictable cash flow as security, such bonds could not be issued. However, bonds have been issued by government entities that have an "expected payment schedule," with the issuance documents making it clear that if an expected payment is missed there is no default.¹²⁶ The risk of the final payment not occurring until, say, 45 years after the bonds were issued could be worked into the price of the bonds to begin with. One way to cut down on the cost of this risk would be to bundle the deferred assessment bonds of many areas.¹²⁷

And it is not just assessment law that could be changed. Mello-Roos law could be similarly altered to allow for deferred payments, thereby encouraging their use in developed areas. It is also possible to eliminate schools from the list of projects available to be funded, thus eliminating the subsidy given to suburban development of schools. A Massachusetts Mello-Roos-type proposal does not

123. This is the classic problem with the property tax in general, one mitigated, according to Martin, first by informal tax privileges, and now by property tax limitation measures such as Proposition 13. See MARTIN, *supra* note 88.

124. That is, property taxes beyond some trigger, say as a percentage of income, would only become due when a property is sold (there would be some rate of interest, say tied to the municipal bond rate). Virginia seems to be on the way to allowing for experimentation with such a system. See S.J. Res. 354, 2007 Sess. (Va. 2007) (allowing localities to defer up to 20% of property tax). Since this proposal is a constitutional amendment, it must pass the legislature one more time and be approved by a majority of voters. See VA. CONST. art. XII, § 1.

125. Shoup, *supra* note 122, at 417–20.

126. This is how (loosely) the bonds secured by payments from the Master Tobacco Settlement are structured.

127. At any rate, allowing such bonds, structured somewhat oddly but to advance a public purpose, to remain marketable despite these features seems a proper use of the federal tax exemption. In contrast, I would agree with those who think that the usual effect of the tax exemption is just to make otherwise marketable and affordable projects a little cheaper at the cost of a huge aggregate subsidy from the federal government. Though I argue above that it would be advisable to use assessment-type in existing communities, I acknowledge that this sort of exercise in direct democracy might be inherently problematic because, for instance, ballot measures are a take-it-or-leave-it proposition put before voters by highly interested elites. See Elizabeth Garrett & Mathew D. McCubbins, *When Voters Make Laws: How Direct Democracy is Shaping American Cities*, 13 PUB. WORKS MGMT. & POL'Y 39 (2008); Kogan & McCubbins, *supra* note 12, at 22 (arguing that "special assessments could increase the slack between citizen preferences and government policy").

include schools as a permitted type of project.¹²⁸ Mello-Roos bonds could only be allowed in certain geographic areas to discourage sprawl; alternatively, Mello-Roos bonds can simply not be allowed for new developments.

It would also be possible to add to the list of projects that Mello-Roos bonds can be used for, such as affordable housing. California law requires that local communities zone for at least a minimal level of affordable housing.¹²⁹ One well-known shortfall of this regime is that it does not have a reliable enforcement mechanism.¹³⁰ That said, the moment of development (or redevelopment) is a time when the state has powerful leverage to affect development patterns by providing financing (and to some extent the state already uses this leverage).¹³¹ This suggests that it would be wise to require that some portion of Mello-Roos financing be used to build affordable housing.¹³² However, as noted above,¹³³ affordable housing is not a permitted use for Mello-Roos financing, and the California Governor has vetoed attempts to change this.

To sum up, the case of Serrano illustrates the internal and external political constraints. To begin with the internal constraint,

128. See *supra* note 10 (defining “Improvement” in Massachusetts House Bill 159). There is obviously something paradoxical, and almost unsavory, in advocating a *reduction* in ways to finance schools. Nevertheless, nothing in this Article has anything to do with the private building of schools, only with the rules governing the very limited public resources dedicated to school construction, and from this perspective it is at least arguable that there could be a net normative improvement across several different registers if different local financing tools were made available for school construction.

129. California Housing Element Law, CAL. GOV’T CODE §§ 65580–65589.8 (2009).

130. As summarized in a recent (and rather thorough) report:

Two fundamental problems hinder the effectiveness of the housing element law. First, the law requires local governments to plan for housing, but contains no enforcement mechanism. There are few incentives to encourage reluctant communities to adequately plan and no meaningful consequences when they fail to do so.

Second, the focus of the housing element law is on planning rather than performance. So even when jurisdictions have plans approved by the State, local communities do not have to demonstrate that they have done their part to ensure that planned housing actually gets built. General plans are easily amended to accommodate specific projects, undermining on a project-by-project basis the long-term housing goals.

LITTLE HOOVER COMM., REBUILDING THE DREAM: SOLVING CALIFORNIA’S AFFORDABLE HOUSING CRISIS v (2002) (on file with the University of Michigan Journal of Law Reform), available at <http://www.lhc.ca.gov/lhcdir/165/report165.pdf>.

131. *Id.* at 16 (“The vast majority of local funding for affordable housing comes from redevelopment agencies.”). There are also considerable resources directed towards affordable housing by the federal and state governments. *Id.* at 11–16.

132. *Cf. id.* at 24 (“The State should focus on fiscal incentives that would encourage communities to approve and build multifamily housing, in-fill housing and housing close to transit centers and jobs.”).

133. See *supra* note 22.

there is simply no good reason to believe that the set of jurisdictions that would have developed in California absent the availability of Mello-Roos financing would be less efficient than the set that have resulted with Mello-Roos. There is, relatedly, no good reason to believe that the set of jurisdictions that would have resulted from a somewhat different Mello-Roos law would have been less efficient. Mello-Roos law makes it easier to build new schools in new communities; it could just as well have made it easier to build solar panels on the roofs of homes in new communities. A different kind of bond could have targeted subsidies at infill-pattern development.

Looked at externally, Serrano would seem to represent the Tiebout model leaping into the absurdly inefficient. It seems very doubtful that this development has internalized the cost of the environmental degradation associated with this pattern of development, much less the cost of racial segregation. To be sure, without government regulation, it is common for private actors to avoid internalizing the full cost of their actions. Nevertheless, as has been laid out, these private actions were subsidized by government regulation; hence the claim that the Tiebout model did not slide into the absurdly inefficient, but *leapt* there, propelled by government subsidy. And now we not only have many homeowners who cannot afford their mortgages, but many homes that do not justify the resources spent in constructing them to begin with.

3. A Note on the Deep Roots of the Appeal of the Tiebout Model

The trip from Samuelson to Tiebout and, as I argue here, back again to Samuelson and “welfare politics,” is a venerable one (and it is over-determined). As Hirschman has famously argued, economists tend to favor the neatness of mechanisms that operate by exit in contrast to the messiness of political systems that operate through voice.¹³⁴ Indeed, Hirschman himself¹³⁵ and J.G.A. Pocock

134. As Hirschman put it, “[exit] is neat—one either exits or one does not; it is impersonal The economist tends naturally to think that his mechanism is far more efficient and is in fact the only one to be taken seriously.” ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 15–16 (1970). As an example of the economist’s “blindspot” to voice, Hirschman notes Milton Friedman’s proposal to make it easier for parents to have their children exit their schools—somehow it is just obvious that this is preferable to parents using voice directly to change their schools. *Id.* at 16–17. To be sure, Hirschman notes that political discourse has been at least as blind to the import and value of exit—it is worth exploring the political implications of the use of exit precisely because exit is a powerful force and one that, I think, has a proper place in the local government landscape. *Id.* at 17.

135. See generally ALBERT O. HIRSCHMAN, *THE PASSIONS AND THE INTERESTS* (1977).

have placed the economist's embrace of exit within a larger tradition of political philosophy in which making decisions through a political process has always been a source of anxiety. The anxiety arises, argues Pocock, because in the political realm we are reliant on one another's virtue. But, as Samuelson noted, we all have an incentive to shirk our duties as concerns public goods. Even worse, we all might not agree on the production of public goods, and no one might be able to bring us all together.¹³⁶

This was the ambivalent tradition inherited by the founders,¹³⁷ who, at least in the constitutional structure that they eventually adopted, seemed to abandon the quest for virtue. That is, as noted above following Gordon Wood, the founders did not create a constitutional order that would rely on the emergence of virtuous political leaders who could transcend local and narrow interests. There are only narrow interests that are set against one another.

Yet from within and without the formal structure of the Constitution, there remained concerns that the system could not survive without a modicum of civic virtue.¹³⁸ For one, the founders remained concerned that the franchise be limited to those who were arguably economically self-sufficient.¹³⁹ Many of the founders, especially Thomas Jefferson,¹⁴⁰ continued to use the language of civic virtue, and J.G.A. Pocock argues famously and persuasively that the vast frontier, which seemed to provide an endless opportunity to create independent yeoman farmers, was seen as a way to sustain a

136. Just because the concern with politics is venerable does not mean it is correct. See, e.g., Donald Wittman, *Why Democracies Produce Efficient Results*, 97 J. POL. ECON. 1395 (1989) (arguing that, at the very least, there is no reason to believe that political markets are less efficient than economic markets).

137. MACHIAVELLIAN MOMENT, *supra* note 57, at 407.

138. As Pocock puts it (following Wood), "the Federalists talked both as if virtue was to be restored and as if it had vanished and must be replaced by new paradigms." *Id.* at 520. Or as Wood himself puts it:

[O]ut of the clashing and checking of this diversity [of power and interests] Madison believed the public good, the true perfection of the whole, would somehow arise. The impulses and passions would so counteract each other, so neutralize their potencies, as America's religious sects had done, that reason adhering in the natural aristocracy would be able to assert itself and dominate.

Wood, *supra* note 57, at 605–06.

139. Cf. MACHIAVELLIAN MOMENT, *supra* note 57, at 528.

140. Samuel Fleischacker, *The Impact on America: Scottish Philosophy and the American Founding*, in *THE CAMBRIDGE COMPANION TO THE SCOTTISH ENLIGHTENMENT* 316, 320 (Alexander Broadie ed., 2003). Even thinkers like Adam Smith and James Madison did not eschew civic virtue. See *id.* at 328 ("[L]ike Smith, [Madison] sees the liberty that . . . gives rein to 'interest' as compatible with a republic concerned, for the most part, to foster virtue.").

virtuous citizenry for a long time to come.¹⁴¹ Indeed, from this perspective, with the closing of the frontier, the American embrace of the homeowner carefully tending his plot and participating in his local government is arguably just a further refinement of the need for a kind of supplemental system that creates *citizens*.¹⁴²

Considered from this very broad perspective, this Article is simply another confirmation that we cannot escape politics and, in particular, cannot escape debates about how our values are to be expressed through the creation and allocation of public goods, even at the local level and even when there is robust jurisdictional competition. The external political constraint counsels that even if the austere Tiebout model can deliver efficiency gains in the real world, we need to decide that these efficiency gains are sufficient given the costs to other values that a Tiebout dynamic imposes. One's anti-Tiebout interlocutors in this context might be surprising, since in many ways small-government anti-tax movements have done more than anyone else to undermine the Tiebout model. Second, the internal political constraint counsels that it is inherent to even a fully functioning Tiebout model that political choices must be made that will impact which set of local government jurisdictions we are likely to live in. There is nothing inconsistent with the Tiebout model in offering a financing mechanism that favors infill development or to stop offering a financing mechanism that subsidizes suburban development. The two types of political constraints are not mutually exclusive. If we select for bundling

141. MACHIAVELLIAN MOMENT, *supra* note 57, at 533–36; *see also* WOOD, *supra* note 57, at xii.

142. Of course, it is a matter of dispute just what kind of citizens we are or should be in the process of creating. As Schragger puts it (in his review of Fischel):

Fischel, however, gives us hints throughout the text that something more than a hardheadedness about human motivations and a faith in markets animates his glowing portrait of American local government. Fischel is also something of a romantic, an admirer—as he writes—of the “pluck” of those who set out to create their own governments, and a believer in the “uniquely American process of bottom-up, local self-governance” (p. 260). This belief in local “pluck” and an obstinate faith in the rationality of residential property owners produces the “homevoter”—the new American freeholder, reimagined as a crusading corporate shareholder in the market for good government.

This resurgence of the freeholder as the engine of good government should not come as a complete surprise: the conventional political wisdom that only property owners could be trusted with self-government lasted well into the twentieth century.

Richard Schragger, Book Review, *Consuming Government*, 101 Mich. L. Rev. 1824, 1856 (2003) (reviewing FISCHEL, *supra* note 39). As noted earlier, to the extent Fischel's citizens ought also vote for higher level redistribution, then merely being educated as a homevoter does not appear to be sufficient.

rules that edge the set of Tiebout jurisdictions towards greater equality and diversity, then obviously the Tiebout model is extracting less of a price in terms of these norms.

CONCLUSION: WE CAN DECIDE TO DO BETTER

It is commonly observed that the current economic crisis began in the American housing market and cannot be resolved until that market is stabilized. This very sensible intuition must be true to a considerable extent given that American homes are the largest asset of the world's largest group of consumers. To date, most analyses of the crisis emphasize how shoddy lending practices put too many Americans into homes they could not afford. There has been much less consideration as to whether the houses built were the wrong houses—ones that have had their value slashed partly because they were overvalued to begin with. It is my contention that part of the problem we are facing is that we subsidized the value of houses that were of marginal value by every metric, including a simple economic one. Tighter lending regulation will attend to the incentives of the buyers and lenders, but we also need to attend to the incentives of the builders. For too long, local government law and its interaction with federal tax law has been ignored on the theory that local governments should be left alone to compete for and reach efficient bargains. This needs to stop, and the first step is to recognize that the local government landscape can only very imperfectly be compared to a free and transparent market for goods and services. At the very least, there are equally efficient sets of jurisdictions that can be selected for by operation of local government law and we should consciously choose to aim for those that better approximate our norms of social justice and environmental sustainability. It has turned out that extreme adherence to the market analogy has pushed us to adopt a development pattern that is objectively suboptimal—we as a society have paid more for sprawl pattern development than it is worth.